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Depreciation: MACRS

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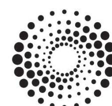

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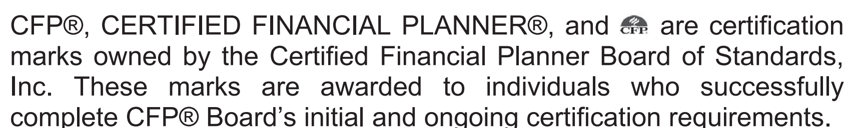
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Depreciation: MACRS (DDETG10)

OVERVIEW

COURSE DESCRIPTION:	This interactive self-study course will allow a user to gain a thorough, practical understanding of ACRS, MACRS, and ADS. Follow examples calculating alternative minimum tax depreciation and luxury automobile caps on annual cost recovery.
PUBLICATION/REVISION DATE:	November 2010
PREREQUISITE/ADVANCE PREPARATION:	Basic knowledge of taxation
CPE CREDIT:	8 QAS Hours, 8 Registry Hours
CTEC CREDIT:	8 CTEC Federal Hours, and 0 CTEC California Hours
	Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self-study. You may also visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours.
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CFP® CREDIT:	4 CE Hours – CFP® Credit hours are half the number of CPE credit hours
FIELD OF STUDY:	Taxes
EXPIRATION DATE:	**November 30, 2011**
KNOWLEDGE LEVEL:	Basic

LEARNING OBJECTIVES

Lesson 1: Depreciation of Tangibles

Completion of this lesson will enable you to:

- Identify costs that are capitalized and recovered through depreciation or amortization.
- Calculate depreciation allowed or allowable.

Lesson 2: MACRS—Recovery Periods and Modifying Conventions

Completion of this lesson will enable you to:

- Determine recovery periods.
- Apply modifying conventions.

Lesson 3: Allowable Depreciation Methods and the IRS Optional Tables

Completion of this lesson will enable you to:

- Identify allowable depreciation methods.
- Utilize the IRS optional tables and those allowed in subsequent years.

Lesson 4: More on Using the IRS Optional Tables

Completion of this lesson will enable you to:

- Utilize the IRS optional tables with early disposition of real, mid-quarter and half-year properties.
- Utilize a general asset account, calculate gain or loss on dispositions and identify items to be deleted from a GAA.

Lesson 5: Alternative Depreciation System and Alternative Minimum Tax

Completion of this lesson will enable you to:

- Identify property excluded from MACRS.
- Compute depreciation for the Alternative Depreciation System (ADS) and Alternative Minimum Tax (AMT).

Lesson 6: Short Tax Years, IRC Section 179 and Bonus Depreciation

Completion of this lesson will enable you to:

- Identify MACRS deductions in a short tax year.
- Identify IRC Sec. 179 property and property qualifying for special (bonus) depreciation.

Lesson 7: Adjustments to Basis, Luxury (Passenger) Automobiles, Light Vans and Trucks, Listed Property and Changes in Use

Completion of this lesson will enable you to:

- Identify the limitations on cost recovery, passenger automobiles and light vans and trucks.
- Recognize listed property.

Lesson 8: Amortization of Intangibles

Completion of this lesson will enable you to:

- Compute amortization of start-up and organizational costs and intangible property in general.
- Identify IRC Sec. 197 intangibles.

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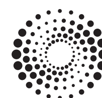

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To enhance your learning experience, the final examination questions are located throughout the course reading materials. Please look for the exam questions following each lesson.

Testing Instructions for Examination for CPE Credit 157

Lesson 1: Depreciation of Tangibles

Introduction

In this lesson, you will learn the general regulatory history behind the depreciation of tangibles, how to distinguish between costs that can be recovered through depreciation and costs that must be capitalized, and the allowed or allowable deductions for depreciation. This lesson contains an in-depth discussion of each of these requirements.

Learning Objectives

Completion of this lesson will enable you to:

- Identify costs that are capitalized and recovered through depreciation or amortization.
- Calculate depreciation allowed or allowable.

Background

Note: All references in this course are to IRC sections, regulations, court cases, Internal Revenue Service pronouncements, and other legislative authorities.

The accelerated cost recovery system (ACRS) was introduced by **the Economic Recovery Tax Act of 1981 (ERTA).** Prior to 1981, depreciation deductions were fairly unstructured and the calculations were open to many interpretations. ACRS severely limited the taxpayer's options.

The Tax Reform Act of 1986 (TRA '86) was a major revision of ACRS. Post-TRA '86 depreciation methods are referred to as modified ACRS (MACRS) or **new** ACRS and pre-TRA '86 depreciation methods are referred to as ACRS.

This course will focus on amortization of intangibles and MACRS cost recovery of tangibles.

IRC Sec. 167(a) is the basic authority for both depreciation and amortization deductions. IRC Sec. 168 contains the detailed rules for MACRS depreciation. IRC Secs. 167 and 168 are interdependent. IRC Sec. 167(a) states that any reference to IRC Sec. 167 includes MACRS deductions claimed under IRC Sec. 168. The amortization of some intangibles is authorized by various IRC sections that will be discussed, including IRC Sec. 197, which covers the rules for the amortization of purchased intangibles.

IRC Sec. 167(a) allows "… as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—(1) of property used in a trade or business; or (2) of property held for the production of income."

The property must be something that wears out, decays, gets used up, becomes obsolete or loses its value from natural causes.

Prior to 1981, to calculate the depreciation deduction, a taxpayer had to determine the following:

- Salvage value
- Useful life
- How to allocate basis over its useful life

Salvage value is an estimated value of property at the end of its useful life (not used under ACRS or MACRS). **Useful life** is an estimate of how long an item of property can be expected to be usable in a trade or business or to produce income. **Adjusted basis** is the original cost of property plus certain additions and improvements minus certain deductions, such as depreciation allowed or allowable and casualty losses.

Allocation methods for depreciation include the following:

- Straight-line method
- Declining-balance method not to exceed twice the straight-line rate (e.g., double-declining-balance method)
- Sum-of-the-years'-digits method
- Any other consistent method, such as the units-of-production method

Prior to 1971, taxpayers were fairly free to determine each of these elements based on their facts and circumstances (usually previous experience or the experiences of others). It would not be unusual for two different companies to depreciate the same $10,000 asset in materially different ways. Taxpayers became extremely aggressive in their definitions of salvage value and useful life since the only way to be proven wrong was through an audit.

In 1971, Congress limited choices of useful life and salvage value by installing the class life asset depreciation range (CLADR) based on the type of industry in which the asset was used. Taxpayers were given a high and low range for useful lives and salvage value. Taxpayers were required by law to stay within the published ranges. A modified form of the CLADR is still in use today in the MACRS system.

Depreciation methods were modified again in 1981 with the introduction of the accelerated cost recovery system (ACRS).

ACRS was designed to both simplify and unify depreciation calculations. Its effect was to reduce most depreciation calculations to mechanical computations that are no longer based on facts and circumstances.

Salvage value was set to zero for all assets, and choices of useful lives were severely limited.

ACRS recovery tables were based on the half-year convention; the 150%-declining-balance method was the only allowable method. (Low-income housing qualified for 200%-declining-balance recovery.) Taxpayers could elect straight-line recovery over a limited choice of recovery periods.

The modifications to ACRS (the new MACRS) increased useful lives for most assets and limited buildings to the straight-line recovery method. MACRS applies to most tangible property placed in service after 1986.

Costs That Are Capitalized and Recovered through Depreciation

In this lesson, we will cover some of the basic concepts that underlie depreciation, which is essentially the process of recovering the cost of property over the time it is being used. It is important to distinguish between costs that can be currently deducted and those that must be capitalized. It is equally important to be able to distinguish capitalized costs that can be recovered through depreciation from those that can be recovered only when the underlying property is sold or abandoned.

Whether to capitalize or deduct an expenditure is sometimes a difficult question to answer.

IRC Sec. 263 provides that “no deduction shall be allowed for any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate.”

The primary distinction between an expense and a capital expenditure tends to be based on whether the useful life of an asset extends beyond one year. Generally, if the useful life is one year or less, the entire cost is deductible as an expense from gross income.

The costs incurred while making improvements to a business asset are capital expenses if the improvements:

- Add to the value of the asset,
- Appreciably lengthen the time it can be used, or
- Adapt it to a different use.

The courts and the IRS have held that improvements include the following and should be capitalized:

- New electric wiring
- A new roof
- A new floor
- New plumbing
- Bricking up windows to strengthen a wall
- Lighting improvements

It is not always easy to determine if a repair or replacement increases the value of property, makes it more useful or lengthens its life. IRS Pub. 535 gives examples of the difference between a repair and a capital improvement.

- **Vehicles:** Repairs made to a business vehicle are deductible expenses. Amounts paid to recondition and overhaul a business vehicle, however, are capital expenses.
- **Roads and Driveways:** The cost of building a private road on business property and the cost of replacing a gravel driveway with a concrete one are capital expenses that may be recovered through depreciation. The cost of maintaining a private road on business property, however, is a deductible expense.

IRS Pub. 535 also gives several examples of the difference between a currently deductible item and a capital expenditure based on the 1-year rule.

- **Tools:** Amounts spent for tools used in a business are generally deductible expenses if the tools have a life expectancy of less than one year.
- **Professional Libraries:** You can deduct the cost of any technical books, journals and information services you use in your business that have a useful life of one year or less in the same way as any other business expense. Materials with a longer life must be capitalized.

For a limited number of specialized expenditures, the taxpayer can choose between capitalizing and expensing. These include the following:

- Carrying charges
- Research and experimental costs
- Drilling and development costs
- Exploration costs
- Circulation costs of magazines, newspapers and periodicals
- Costs of removing barriers to the disabled and the elderly

In some cases, the costs cannot be completely recovered in the current year but are amortized over a relatively short life. The alternative minimum tax (AMT) may apply if any of the costs listed (except carrying charges and the costs of removing architectural barriers) are expensed instead of being capitalized. If you would like more information about any of these items, IRS Pub. 535 provides a good starting point.

Property that **cannot** be depreciated includes the following:

- Land
- Property placed in service and disposed of in the same year
- Inventory
- Rented or leased property
- Some term interests in property created or acquired after July 27, 1989
- Intangibles specifically required to be amortized (covered in Lesson 8)

Land Preparation Costs: Some costs incurred in preparing land for business use, such as landscaping, can be depreciated. These costs must be so closely associated with other depreciable property that you can determine a life for them along with the life of the associated property. Other land preparation costs must be added to the basis of the land and cannot be depreciated because they have no determinable life.

Land preparation costs should be distinguished from the circumstances where the land, landscaping and buildings are purchased with the intention of pulling everything down and starting over to build a new structure. In this case, all the costs are allocated to the land and cannot be depreciated.

Example 1: You constructed a new building for use in your business and paid for grading, clearing, seeding and planting bushes and trees. Some of the bushes and trees were planted right next to the building while others were planted around the outer border of the building lot.

If you replaced the building, you would have to destroy the bushes and trees right next to it. Because these bushes and trees have a determinable useful life that is closely associated with the building, you can depreciate them as land preparation costs.

Depreciation Allowed or Allowable

Determining when depreciation starts and stops is important for the following three reasons:

1. Proper allocation of deductions against income
2. Determining the amount of gain or loss realized if the property is sold or abandoned
3. Determining the amount of gain subject to depreciation recapture

The cost or other basis of property must be reduced by the total amount of allowable deductions for depreciation, amortization, obsolescence or depletion for each taxable year the property was held by the taxpayer since February 28, 1913 (IRC Sec. 1016(a)(2)). Regulation Sec. 1.1016-3(a)(1) provides, in general, adjustment to the basis when a deduction is claimed.

For taxable periods beginning on or after January 1, 1952, the cost or other basis of property shall be decreased for exhaustion, wear and tear, obsolescence, amortization and depletion by the greater of the following two amounts:

1. The amounts allowed as deductions in computing taxable income, to the extent that these amounts result in a reduction of the taxpayer's income taxes
2. The amount allowable for the years involved

Key Term: The **allowable depreciation** is the amount of depreciation that a taxpayer is entitled to deduct from gross income under the laws and regulations in effect for the year the asset was acquired, whether or not that amount resulted in a tax benefit. This provision punishes careless taxpayers and prevents taxpayers from foregoing depreciation to save basis.

Generally, if the depreciation deducted (allowed) as a tax deduction in any taxable year exceeds that which is allowable, the basis of the property must be reduced by the amount allowed.

If a taxpayer does not take a depreciation deduction in any year, adjustments to the basis of the property for depreciation allowable are determined by using the straight-line method of depreciation (Regulation Sec. 1.1016-3(a)(2)(i)).

However, the taxpayer has the right to File Form 3115 and make an adjustment to take an actual deduction for the allowable depreciation in the year of disposition.

Example 2: An asset was purchased for $10,000. The useful life of the asset was seven years. Depreciation deducted (allowed) for the first five years was $3,500. The correct amount (allowable depreciation) should have been $7,769. (The taxpayer took too little depreciation in one year and completely skipped another year.) The taxpayer's remaining basis in the asset at the end of five years was $2,231, even if the adjustments to income (depreciation deductions) were barred by the statute of limitations.

Gain or Loss on Sale of Assets

The difference between the amount realized and the adjusted basis of property sold is the realized gain or loss on disposition. The adjusted basis is the cost decreased by the allowed or allowable cost recovery deductions and increased by capital improvements.

General Rule: For the purposes of depreciation recapture under IRC Sec. 1245, gain is treated as ordinary to the extent of depreciation allowed or allowable. Once again, the general rule is that the depreciation and amortization amounts used in determining the ordinary portion of the gain are the amounts that are either allowed or allowable (IRC Sec. 1245(a)(2)(A)).

The meanings of **allowed** and **allowable** are generally the same for this purpose as they are for determining basis adjustments for depreciation and amortization.

There is one difference here. If the taxpayer can prove by adequate records or other sufficient evidence that the amount actually allowed (deducted) for depreciation or amortization for any period was less than the amount allowable, the amount actually allowed (deducted) for the period is the amount used (IRC Sec. 1245(a)(2)(B)).

Example 3: If depreciable property is sold, you must determine the amount of gain subject to ordinary income recapture. The allowable depreciation was $1,000, but your business records and other evidence indicated that you actually deducted only $800. The $800 figure will be used (Reg. Sec. 1.1245-2(a)(7)).

Correcting the Amount of Depreciation Claimed

The easiest way to correct a miscalculation is to file an amended return.

However, if the incorrect amount of depreciation was deducted on two or more consecutively filed tax returns, the taxpayer has adopted a method of accounting for that property. In that case, the taxpayer cannot change the depreciation deduction by filing amended returns, even if the statute of limitations is open.

It is fairly easy to change a method of accounting for depreciation and claim the correct amount of depreciation. Most changes in the method of accounting require the consent of the Commissioner of the Internal Revenue Service (IRS), but the rules are eased here.

In this case, it is possible to obtain automatic consent from the Commissioner if the taxpayer has:

- Deducted less than the allowable amount of depreciation for the property in at least two years immediately preceding the year of change;
- Completed Form 3115 and made the appropriate IRC Sec. 481 adjustment to adjust for any unclaimed allowable depreciation. This "negative" adjustment is taken into account in the year of change and is reported under "other adjustments" on the taxpayer's income tax return. The adjustment can be made in any change year, including the year of disposition. If the incorrect deduction was taken for only one year, the taxpayer can elect to use Form 3115 instead of filing an amended return.

Note: For more information, see Rev. Proc. 2009-39.

Depreciation deductions begin when property is placed in service and end when the property is retired from service.

The precise date a piece of property is placed in service is extremely important in the MACRS system (as discussed in a later lesson) for determining modifying conventions.

Placed in Service: For depreciation purposes, property is placed in service when it is ready and available for a specific use, whether in trade or business, the production of income, a tax-exempt activity, or a personal activity.

Property is considered to be in service when it is ready and available for its specific use, even if it is not actually used before the end of the tax year.

Example 4: You bought a house and used it as your personal home for several years before you converted it to rental property. Although its specific use was personal and no depreciation was allowable, you placed the home in service when you began using it as your home. When you converted it to rental property, its use changed to income-producing and you can begin claiming depreciation deductions.

You bought a planter for your farm business late in the year after harvest was over. You take a depreciation deduction for the planter for that year because it was ready and available for its specific use.

Idle Property: A deduction for depreciation on property used in a business must be claimed even if the property is temporarily idle.

Example 5: The taxpayer stops using a piece of machinery because there is a temporary lack of market for its product. The taxpayer must continue to deduct depreciation on the machinery.

Retired from Service: Property is retired from service when it is permanently withdrawn from use in a trade or business or from use in the production of income. Depreciation stops only when this happens.

You can retire property from service by selling, exchanging, abandoning or destroying it.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. Salvage value is **not** used in the calculation of depreciation under which of the following methods?

   a. Facts and circumstances.

   b. ACRS.

   c. Class life and asset depreciation range.

2. Mack Corp. purchased a new building this year for $250,000. It has an estimated useful life of 10 years and an estimated salvage value of $20,000. What is the depreciable basis?

   a. $20,000.

   b. $230,000.

   c. $240,000.

   d. $250,000.

3. In which of the following scenarios is the expenditure a capital expenditure, instead of an expense?

   a. A truss table is extended at a cost of an additional $25,000 to allow the table to build two trusses at one time instead of just one.

   b. A company is purchasing all of its employees new laptops and has determined that they will have a useful life of one year.

   c. A company decides to redecorate its office to improve the look. The carpet is replaced and the walls are painted in the main areas.

4. Which of the following is an example of land preparation costs that can be recovered through depreciation?

   a. You constructed a new building for use in your restaurant business and paid for grading, clearing, and constructing a parking lot right next to the building.

   b. You constructed a new building for use in your business and paid for grading, clearing, seeding and planting bushes and trees in the outer border of the building's parking lot. It is very unlikely that these trees would be disturbed if modifications were made to the building or the parking lot.

   c. You purchased land that contained many trees and shrubs. You paid for clearing all of the trees from the site so you could construct your factory.

5. Which of the following scenarios is accurate?

   a. Your company discovered in Year 4 that it had been incorrectly depreciating the equipment it placed in service in Year 1. You can amend all open years to fix as much of the mistake as possible.

   b. Your company has excess capacity and is permanently shutting down a factory. It has listed the property for sale. No depreciation should be taken since the property has been permanently withdrawn from use.

   c. Your company has excess capacity and is temporarily shutting down a factory. It anticipates that it will be shut for four years. No depreciation should be taken while the factory is idle.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

1. Salvage value is **not** used in the calculation of depreciation under which of the following methods? **(Page 2)**

   a. Facts and circumstances. [This answer is incorrect. Prior to 1971, taxpayers were fairly free to determine each of these elements based on their facts and circumstances (usually previous experience or the experiences of others). It would not be unusual for two different companies to depreciate the same $10,000 asset in two materially different ways. Taxpayers became extremely aggressive in their definitions of salvage value and useful life since the only way to be proven wrong was through an audit.]

   b. ACRS. [This answer is correct. In 1981, ACRS was designed to both simplify and unify depreciation calculations. Its effect was to reduce most depreciation calculations to mechanical computations that are no longer based on facts and circumstances. Salvage value was set to zero for all assets, and choices of useful lives were severely limited. ACRS recovery tables were based on the half-year convention; the 150%-declining-balance method was the only allowable method. (Low-income housing qualified for 200%-declining-balance recovery. Taxpayers could elect straight-line recovery over a limited choice of recovery periods.]

   c. Class life and asset depreciation range. [This answer is incorrect. In 1971, Congress limited choices of useful life and salvage value by installing the class life asset depreciation range (CLADR) based on the type of industry in which the asset was used. Taxpayers were given a high and low range for useful lives and salvage value. Taxpayers were required by law to stay within the published ranges. A modified form of the CLADR is still in use today in the MACRS system.]

2. Mack Corp. purchased a new building this year for $250,000. It has an estimated useful life of 10 years and an estimated salvage value of $20,000. What is the depreciable basis? **(Page 2)**

   a. $20,000. [This answer is incorrect. Salvage value is not the depreciable basis. IRC Sec. 168(b)(4).]

   b. $230,000. [This answer is incorrect. Salvage value does not apply in this situation. Since the property was purchased this year, MACRS must be used. This means salvage value does not reduce the depreciation basis. IRC Sec. 168(b)(4).]

   c. $240,000. [This answer is incorrect. MACRS does not consider any salvage value when determining the depreciable basis. IRC Sec. 168(b)(4).]

   d. $250,000. [This answer is correct. Salvage value does not reduce the depreciable basis when using MACRS. The depreciable basis is the entire cost of the building (the total cost minus the cost allocated to the land). IRC Sec. 168(b)(4).]

3. In which of the following scenarios is the expenditure a capital expenditure, instead of an expense? **(Page 3)**

   a. A truss table is extended at a cost of an additional $25,000 to allow the table to build two trusses at one time instead of just one. [This answer is correct. Although the additional expenditure was added to an existing asset, the addition did add to the value of the asset and should be treated as a capital expenditure per the Internal Revenue Code.]

   b. A company is purchasing all of its employees new laptops and has determined that they will have a useful life of one year. [This answer is incorrect. Generally, if an asset's useful life is one year or less, the entire cost is deductible as an expense from gross income according to the IRS Code.]

   c. A company decides to redecorate its office to improve the look. The carpet is replaced and the walls are painted in the main areas. [This answer is incorrect. The redecorating of the office does not appreciably lengthen the time that the facility can be used, so the expense should be expensed instead of capitalized as stated in the IRS Code.]

4. Which of the following is an example of land preparation costs that can be recovered through depreciation? **(Page 4)**

   a. You constructed a new building for use in your restaurant business and paid for grading, clearing, and constructing a parking lot right next to the building. [This answer is correct. Some costs incurred in preparing land for business use, such as parking lot, can be depreciated. These costs must be so closely associated with other depreciable property that you can determine a life for them along with the life of the associated property. "Right next to the building" implies that reconstruction of the building would generally require reconstruction of the parking lot.]

   b. You constructed a new building for use in your business and paid for grading, clearing, seeding and planting bushes and trees in the outer border of the building's parking lot. It is very unlikely that these trees would be disturbed if modifications were made to the building or the parking lot. [This answer is incorrect. These land preparation costs appear to have no determinable life; therefore, they should be added to the basis of the land.]

   c. You purchased land that contained many trees and shrubs. You paid for clearing all of the trees from the site so you could construct your factory. [This answer is incorrect. Land preparation costs should be distinguished from the circumstances where the land, landscaping and buildings are purchased with the intention of pulling everything down and starting over to build a new structure. In this case, all the costs are allocated to the land and cannot be depreciated.]

5. Which of the following scenarios is accurate? **(Page 7)**

   a. Your company discovered in Year 4 that it had been incorrectly depreciating the equipment it placed in service in Year 1. You can amend all open years to fix as much of the mistake as possible. [This answer is incorrect. If the incorrect amount of depreciation was deducted on two or more consecutively filed tax returns, the taxpayer has adopted a method of accounting for that property. In that case, the taxpayer cannot change the depreciation deduction by filing amended returns, even if the statute of limitations is open. Instead the company would apply for a change in accounting methods and make an IRC Sec. 481 adjustment.]

   b. Your company has excess capacity and is permanently shutting down a factory. It has listed the property for sale. No depreciation should be taken since the property has been permanently withdrawn from use. [This answer is correct. Property is retired from service when it is permanently withdrawn from use in a trade or business or from use in the production of income. Depreciation stops when this happens.]

   c. Your company has excess capacity and is temporarily shutting down a factory. It anticipates that it will be shut for four years. No depreciation should be taken while the factory is idle. [This answer is incorrect. According to IRS regulations, a deduction for depreciation on property used in a business must be claimed even if the property is temporarily idle.]

EXAMINATION FOR CPE CREDIT

Lesson 1

Determine the best answer for each question below. Then log onto our Online Grading Center at **OnlineGrading.Thomson.com** to record your answers.

1. Which of the following would the courts and the IRS be most likely to consider a repair expense rather than a cost requiring capitalization?

   a. Land & Sea Company rewired most of its building to allow its computers to have high-speed Internet access.

   b. After Hurricane Katrina caused structural damage to its building, Old Glory Inc. had to enclose all of the windows on the main floor in order to provide support for the building to pass inspection.

   c. The Speeks Company spent $5,000 replacing tires, hoses and batteries in its fleet of trucks.

   d. After an employee was mugged in the parking lot, Tag Company spent $5,000 upgrading the lighting in all of its outdoor areas.

2. Which of the following is correct concerning allowable depreciation?

   a. No adjustments have to be made to the basis of the property in a year that a taxpayer does not take a depreciation deduction.

   b. Basis does not have to be reduced if tax deduction for depreciation exceeds that which is allowed.

   c. A taxpayer can file a Form 3115 to make an alteration to an actual deduction for depreciation in the year the asset is disposed of.

   d. Do not select this answer choice.

Lesson 2: MACRS—Recovery Periods and Modifying Conventions

Introduction

In this lesson, you will learn what is and what is not covered under modified ACRS (MACRS) and the concepts of recovery periods and modifying conventions as they apply to the mid-month convention, to residential and nonresidential real property, and to the other six classes of MACRS property.

Learning Objectives

Completion of this lesson will enable you to:

- Determine recovery periods.
- Apply modifying conventions.

Recovery Periods

Remember:

- MACRS **must be used** (few exceptions) for tangible assets placed in service after 1986.
- An economic useful life is not considered. Property is placed in classes.
- Salvage value does not apply (IRC Sec. 168(b)(4)).
- There is no distinction between **new** and **used** property.
- There is no deduction for extraordinary obsolescence.

MACRS does not apply to the following property:

- Intangibles.
- Property that the taxpayer properly elects to depreciate under a depreciation method not expressed in terms of years (i.e., units-of-production method).
- Motion picture film and videotape.
- Sound recordings.

We will discuss excluded property at length in Lesson 5.

To recover the cost of property under MACRS, you need to determine the property's applicable:

- Recovery period,
- Required modifying convention, and
- Depreciation method allowed.

The rest of this lesson will discuss the concept of recovery periods. Modifying conventions and allowable depreciation methods are covered in the following lessons.

Most real estate is classified as either:

- Residential rental property (27.5-year recovery period), or
- Nonresidential real property (a 39-year recovery period if placed in service on or after May 13, 1993, or a 31.5-year recovery period if placed in service from 1987 through May 12, 1993).

Note: Although there will be no examples calculating depreciation based on a recovery period of 31.5 years, IRS Table A-7 (Appendix A7) shows the appropriate figures that should be used.

Under MACRS, buildings in these classes are **always** restricted to the straight-line method of cost recovery (IRC Sec. 168(c)).

Planning Note: There are special rules that may apply for alternative minimum tax purposes.

MACRS classifies all personal property and some real property placed into service after 1998 into six categories. The recovery period assigned to each nonreal property category ranges from three to 20 years.

Note: The real property included in these classes is highly specialized and is only a small percentage of the property covered. We will ignore the realty in these six groups and use the term **personalty** (tangible personal property) to describe these classes.

Personalty (Equipment)

There are six classes of equipment and two classes of real estate in the MACRS system. These are summarized in the following paragraphs. First, however, we will talk about the most important ones. Most kinds of personal property are in one of two groups:

- 5-year property
- 7-year property

The most common items included in **5-year property** are autos, computers and peripheral equipment and some office machinery such as copiers and typewriters. The official list is longer, but you are unlikely to see most of these items unless you have clients in that specialty. Other examples of 5-year property are taxis, buses, some trucks, calculators and any property used in research and experimentation. Five-year property also includes some animals, including breeding cattle, dairy cattle and sheep.

Note: Furniture and carpeting used in a residential rental and some furnishing used by customers are recovered over five years. Similar property used outside of these areas will be recovered over seven years.

Most equipment and furnishings are in the **7-year property** group. In fact, if it is furniture or equipment and it is not 5-year property, odds are that it fits right here. This class includes office furniture and fixtures such as desks, files, safes and manufacturing equipment. It also includes any property that does not have a class life and that has not been designated by law as being in any other class.

The other four classes are for specialty items.

The **3-year property** class includes the following:

- Tractor units for over-the-road use
- 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 treated as 3-year property
- Any other horse over 12 years old when placed in service
- Hogs (breeding)
- Qualified rent-to-own property

The **10-year property** class includes the following:

- Water transportation, such as barges and tugs
- Any single-purpose agricultural or horticultural structure
- Any tree or vine bearing fruits or nuts

The **15-year property** class includes certain depreciable improvements made directly to land or added to it, such as shrubbery, fences, roads and bridges. It also includes service station buildings and other land improvements used in the marketing of petroleum and petroleum products (but not facilities related to petroleum and natural gas trunk pipelines).

The **20-year property** class includes farm buildings (other than agricultural or horticultural structures).

Other 15-year property

Qualified Restaurant Property

The American Jobs Creation Act of 2004 created a new category of 15-year property referred to as qualified restaurant property. The provision applied to improvements placed in service after October 22, 2004, and before January 1, 2008. The Emergency Economic Stabilization Act of 2008 extended this provision to property placed in service before January 1, 2010. IRC Sec. 168(e)(7)

Qualified restaurant property is any IRC Sec. 1250 property that is an improvement to a building, placed in service more than three years after the date the building was first placed in service if more than 50% of the building’s square footage is devoted to preparation of, and seating for, on-premises consumption of prepared meals. The Emergency Economic Stabilization Act of 2008 also expanded the definition of qualified restaurant property to include buildings placed in service after December 31, 2008, and before January 1, 2010, if more than 50% of the building’s square footage is devoted to preparation of, and seating for, on-premises consumption of prepared meals. IRC Sec. 168(e)(3)(E)(v)

Qualified Leasehold Improvements

Qualified leasehold improvement property placed in service after October 22, 2004, and before January 1, 2010, is also 15-year MACRS property. These improvements must be made to the interior portion of nonresidential real property. Leasehold improvements that are not qualified leasehold improvement property are generally depreciated as either 39-year real property or 27.5-year residential rental property. IRC Sec. 168(e)(3)(E)(iv)

Residential Rental Property: Real property such as a rental home or structure (including a mobile home) if 80% or more of its gross rental income for the tax year is from dwelling units.

If any part of the building or structure is used for personal use, its gross rental income includes the fair rental value of the part occupied.

A dwelling unit is a house or apartment used to provide living accommodations in a building or structure. A dwelling unit does **not** include a unit in a hotel, motel, inn or other establishment where more than half the units are used on a transient basis.

Low-income housing is also included in this class.

Nonresidential Real Property: IRC Sec. 1250 property that is **not** either of the following:

- Residential rental property
- Property with a class life of less than 27.5 years

Note: The Tax Extenders and AMT Relief Act of 2008 extended or added the following provisions:

Qualified Leasehold Improvements	Property placed in service in 2008 and 2009	The 15-year straight-line cost recovery allowed for qualified leasehold improvement property first allowed in 2004 is extended for property placed in service prior to 2010.
Qualified Restaurant Improvements	Property placed in service in 2008 and 2009	The 15-year straight-line cost recovery allowed for qualified restaurant improvement property is extended two years. In addition, eligible property is expanded to include buildings placed in service in 2009.
Qualified Retail Improvement Property	Property placed in service in 2009	The Act provides that any qualified retail improvement property placed in service in 2009 is depreciated straight-line over 15 years. Qualified retail improvement property is any improvement to an interior portion of a building that is nonresidential real property if: • That portion is open to the general public and is used in the retail trade or business of selling tangible personal property to the general public, and • The improvement is placed in service more than three years after the date the building was first placed in service.

Note: Sometimes land is really a land improvement, and a part of a building is really equipment. The identification and separate depreciation of personal property components and land improvements relating to a building is referred to as cost segregation. Building components identified as personal property are usually classified as 5-year or 7-year property and can be recovered using the 200%-declining-balance method. Land improvements generally have a 15-year useful life and can be recovered using the 150%-declining-balance method. Taxpayers who are constructing or purchasing new buildings are generally well served by hiring an expert to do a cost segregation study to identify components that can be recovered more quickly than the building itself.

To recap, MACRS under the general depreciation system (GDS) sets forth the following categories of property under IRC Sec. 168(c):

Category	Recovery Period (General Depreciation System to Be Used for Regular Tax)
3-year property	3 years
5-year property	5 years
7-year property	7 years
10-year property	10 years
15-year property	15 years
20-year property	20 years
Residential rental property	27.5 years
Nonresidential real property if placed in service after May 12, 1993	39 years
Nonresidential real property if placed in service from 1987 through May 12, 1993	31.5 years

Note: The applicable recovery periods are **not** elective. However, taxpayers generally have a second, longer recovery period they can choose instead.

Property is assigned to its recovery period based on the class life listed in Rev. Proc. 87-56, 1987-2 CB 674 and Rev. Proc. 87-57, 1987-2 CB 687. (This information is included in IRS Pub. 946, *How to Depreciate Property*.)

These are updated versions of the information that was used in the class life asset depreciation range (CLADR) system introduced in 1971.

Reminder: Congress originally used CLADR to limit choices of useful life and salvage value based on the type of industry in which the asset was used. Taxpayers were given a high and low range for useful lives and salvage value. Taxpayers were required by law to stay within the published ranges. Now we have a much more structured system: no salvage value and mandated useful lives.

Class lives are determined for specific assets within each recovery category (IRC Sec. 168(e):

Category	Class Life
3-year property	4 years or less
5-year property	5–9 years
7-year property	10–15 years
10-year property	16–19 years
15-year property	20–24 years
20-year property	25 or more years

Reminder: Property "without a class life" (any property that is not listed in Rev. Proc. 87-56) is assigned a seven-year recovery period when calculating depreciation for the general depreciation system (regular tax).

Modifying Conventions Applied to Buildings

Reminder: To recover the cost of property under MACRS, you need to determine the property's applicable:

- Recovery period,
- Required modifying convention, and
- Depreciation method allowed.

Earlier in this lesson, you learned about recovery periods. This section will introduce the concept of modifying conventions and apply the mid-month convention to residential and nonresidential real property.

In Lesson 3, we will cover allowable depreciation methods and pull the pieces together into a calculation of cost recovery under MACRS.

When depreciation was a wide-open arena (pre-1981), taxpayers got to decide how to depreciate an asset in the year it was acquired and the year it was sold. A truly dedicated taxpayer might track the exact number of days that each asset was held and depreciate over exactly that many days. Most taxpayers were not that patient and instead adopted simplifying conventions. Some would take a full year's depreciation in the year an asset was purchased and none in the year it was sold. Others would take a full month's depreciation in the month an asset was acquired or sold **only** if it was placed in service or sold prior to the fifteenth of the month.

Recap: Allowable depreciation in the taxable year in which a convention applies is a fraction of the amount of depreciation that would be allowable for a full taxable year (12 full months). The convention applies in the year the property is placed in service and the year of its disposition or retirement. When rules were tightened up under ACRS and MACRS, specific modifying conventions became mandatory. Buildings must use a mid-month convention. Equipment must use either a mid-quarter or half-year convention.

Note: If an asset is placed in service and disposed of in the same year, no depreciation is allowed under MACRS (Reg. Sec. 1.168(d)-1(c)).

The applicable convention to be used in computing depreciation for nonresidential and residential rental property is the mid-month convention.

This convention applies to all nonresidential real property and residential rental property in the taxable year in which property is placed in service and the year in which it is disposed of or retired from service (IRC Sec. 168(d)(2)).

When a taxpayer buys a building, the taxpayer starts with the month of purchase, counts the remaining months in the tax year, and subtracts 0.5 to adjust for the modifying convention. When the taxpayer sells a building, the taxpayer has to do the same calculation in reverse.

This time the taxpayer starts with January and counts to the month the building is sold. To apply the modifying convention, subtract 0.5.

Note: All of our taxpayers will use the calendar year. To facilitate calculations, decimal fractions will be used in the formulas instead of the percentage (4.17% = .0417).

If a building is placed in service in December, the taxpayer will be able to recover 0.5 of a month of depreciation (one month left in the tax year minus 0.5). One way to calculate this is to multiply the calculation for a full year's depreciation by (0.5 ÷ 12) or .0417.

If the building was purchased in June, the taxpayer would count forward from June and get seven months. The taxpayer would subtract 0.5 month to adjust for the modifying convention. One way to calculate this is to multiply the full year's depreciation by (6.5 ÷ 12) or .5417.

If the taxpayer sells a building in December, the taxpayer will get 11.5 months of depreciation. (There are 12 months, including December, that the building is held and the mid-month convention allows only 0.5 of a month's depreciation for the month of sale.)

You already know that buildings are recovered using the straight-line method and that residential buildings are recovered over 27.5 years. Nonresidential property acquired after May 12, 1993, is recovered over 39 years. Let's use that knowledge and some simple facts to practice applying the mid-month modifying convention.

Example 1: Tom purchased a new office building on November 15, 1995, for $4.4 million. On March 1 of this year, the building was sold; $400,000 of the purchase price was allocated to the land.

First, only $4 million is subject to cost recovery since land is one of those costs that has to be capitalized and cannot be recovered until the asset is sold, abandoned or otherwise disposed of. Second, this is nonresidential property purchased after May 12, 1993, so its recovery period is 39 years. If Tom could claim a full year's depreciation in the year of purchase, he would be entitled to $102,564 ($4,000,000 ÷ 39 years). This is the amount that Tom claimed each year that the building was owned for 12 full months, but the deduction is smaller in both 1995 and this year, because the building was owned for just part of a year.

Since the building was acquired in November, Tom counted forward to December (two months) and then subtracted one-half. The mid-month convention allowed him only 1.5 months out of the full 12 months figure or .125 (1.5 ÷ 12) of $102,564 in 1995 ($12,821 = ($4,000,000 ÷ 39 years) × (.125)).

Example 2: This year on March 1, Tom sold the building. The mid-month modifying convention must be applied again to determine the correct amount of depreciation for the current year. Annual depreciation equals $102,564 ($4,000,000 ÷ 39 years).

This time Tom starts at January and counts to the month of sale (March) and subtracts 0.5. Tom is entitled to 2.5 months of depreciation or .2083 (2.5 ÷ 12) of a full year. The allowable depreciation is $21,364 ($102,564 × .2083). The mid-month modifying convention is applied to each building on an individual basis.

If the taxpayer does not sell the building, the cost recovery in the final year of the recovery period will be its remaining basis. Here is an example of what cost recovery of a residential building held for the full recovery period would look like. Note that nonresidential recovery is the same format with a longer useful life.

Example 3: Residential rental property was placed in service in January. It has an adjusted basis of $100,000. The straight-line depreciation deduction for the first year applying the mid-month convention is $3,485.

$100,000 ÷ 27.5 years	=	$3,636 per year
Depreciation for 11.5 months:		
11.5 months ÷ 12 months	=	.95833 of a year
$3,636 per year × .95833	=	$3,485 depreciation for 11.5 months

For Years 2–27, the depreciation deduction will be $3,636 per year ($100,000 ÷ 27.5 years = $3,636). In Year 28, the deduction will be $1,979.

$100,000 cost	–	($3,485 × 1 year)	–	(26 years × $3,636)	=	
$100,000 cost	–	$3,485 – $94,536			=	$1,979

Let's recap what you should know about buildings at this point:

- For nonresidential real property (39-year class or 31.5-year class) and residential rental property (27.5-year class), the straight-line method of depreciation is required (IRC Secs. 168(b)(3)(A) and (B), IRC Sec. 168(c)).
- The applicable modifying convention for nonresidential real property and residential rental property is the mid-month convention (IRC Secs. 168(d)(2)(A) and (B)).
- The mid-month convention treats all property placed in service or disposed of during any month as placed in service or disposed of on the mid-point of such month. Therefore, depreciation in the first and last months is limited to one-half of the full month (IRC Sec. 168(d)(4)(B)).

Modifying Conventions Applied to Equipment

You've now learned to apply modifying conventions to buildings. The next paragraph will focus on applying modifying conventions to the other six classes of MACRS property. As you will see, the rules are much more complex for this group of assets.

The half-year convention will apply to **all** personal property placed in service during the tax year **unless** the mid-quarter convention applies. If the half-year convention applies:

- All personal property placed in service during the year will receive one-half (0.5) of the amount calculated for the full year, and
- All personal property disposed of during the year will receive one-half (0.5) of the amount calculated for the full year.

Note: It does not matter when the half-year property is disposed of during the year. Half-year property sold on January 1 and on December 31 are both entitled to one-half of the full year's depreciation calculation.

The mid-quarter convention will apply to all personal property placed in service during the year if more than 40% of the total property that is placed in service during the tax year was placed in service during the last three months.

Note: All property from the six personalty classes are combined for this test (personalty = tangible personal property).

Example 4: During the year, a calendar-year taxpayer places the following property in service:

Date	Recovery Class	Cost
February 15	5-year	$350,000
July 15	7-year	$ 50,000

Since none of the property was placed in service in the last quarter (October, November, December), all of the property is half-year property. Depreciation in the year placed in service and the year of sale will be one-half of the full year's calculation.

Example 5: During the year, a calendar-year taxpayer places the following property in service:

Date	Recovery Class	Cost
February 15	5-year	$350,000
November 15	7-year	$100,000

There is property placed in service in the fourth quarter, so you must test for mid-quarter. The fourth-quarter item is not more than 40% of the total ($100,000 ÷ $450,000 = 22.2%). Therefore, all of the property is half-year property. Depreciation in the year placed in service and the year of sale will be half (0.5) of the full year's calculation for each item.

Example 6: During the year, a calendar-year taxpayer places the following property in service:

Date	Recovery Class	Cost
February 15	5-year	$350,000
October 9	27.5-year	$200,000

There is property placed in service in the fourth quarter; however, the fourth-quarter item is residential real estate, so it is ignored for the purposes of this test. Therefore, all of the 5-year property is half-year property. Depreciation in the year placed in service and the year of sale will be one-half of the full year's calculation.

Example 7: During the year, a calendar-year taxpayer places the following property in service:

Date	Recovery Class	Cost
February 15	5-year	$100,000
October 9	7-year	$350,000

There is property placed in service in the fourth quarter, so you must test for mid-quarter. The fourth-quarter items are greater than 40% of the total ($350,000 ÷ $450,000 = 77.8%). Therefore, **all** of the property is treated as mid-quarter property. Depreciation in the year placed in service and the year of sale will be limited based on the number of quarters each property is held.

The adjustment for the mid-quarter convention is not as simple as taking one-half month or one-half year. To apply the mid-quarter convention in the year the property is placed in service, multiply the depreciable basis of the property by the depreciation rate, then multiply by the following fraction:

$$\frac{x - 0.5}{4}$$

Where x is the number of quarters the property was in service (not the quarter it was placed in service).

Property placed in service in the first quarter is adjusted to: $\frac{4 - 0.5}{4} = .875$ of the full year's depreciation amount.

Property placed in service in the second quarter is adjusted to: $\frac{3 - 0.5}{4} = .625$ of the full year's depreciation amount.

Reminder: To apply the mid-quarter convention, multiply the depreciable basis of the property by the depreciation rate, then multiply by the following fraction:

$$\frac{x - 0.5}{4}$$

where x is the number of quarters the property was in service.

Continuing the mid-quarter adjustment—

Property placed in service in the third quarter is adjusted to: $\frac{2 - 0.5}{4} = .375$ of the full year's depreciation amount.

Reminder: Property placed in service in the fourth quarter is adjusted to: $\frac{1 - 0.5}{4} = .125$ of the full year's depreciation amount.

Example 8: During the year, a calendar-year taxpayer places the following property in service:

Date	Recovery Class	Cost
February 1	3-year	$100,000
October 9	7-year	$350,000

There is property placed in service in the fourth quarter **and** the fourth-quarter items are greater than 40% of the total ($350,000 ÷ $450,000 = 77.8%). The depreciation allowed for the February addition must be adjusted by multiplying by (4 – 0.5) ÷ 4 = .875. The depreciation allowed for the October addition must be adjusted by multiplying by (1 – 0.5) ÷ 4 = .125.

Example 9: During the year, a calendar-year taxpayer places the following property in service:

Date	Recovery Class	Cost
May 15	5-year	$100,000
September 30	3-year	$ 90,000
November 19	7-year	$350,000

There is property placed in service in the fourth quarter **and** the fourth-quarter items are greater than 40% of the total ($350,000 ÷ $540,000 = 64.8%).

> **Remember:** To apply the mid-quarter convention, multiply by the fraction (x – 0.5) ÷ 4, where x is the number of the quarters the property was in service.

The depreciation allowed for the May addition must be adjusted by multiplying by (3 – 0.5)/4 = .625. The depreciation allowed for the September addition must be adjusted by multiplying by (2 – 0.5) ÷ 4 = .375. The depreciation allowed for the November addition must be adjusted by multiplying by (1 – 0.5) ÷ 4 = .125.

To apply the mid-quarter convention in a year of disposition, simply follow the rule for buildings but count quarters instead of months and subtract one-half quarter.

Start with the first quarter and count to the quarter the equipment is sold. To apply the modifying convention, subtract one-half quarter.

If the taxpayer sells mid-quarter equipment in December, the taxpayer will get 3.5 ÷ 4 or .875 of the full year's depreciation. (There are four quarters, December is in the fourth quarter, and the mid-quarter convention allows only one-half of a quarter's depreciation for the quarter of sale.)

The counting of quarters in the year of sale is independent of the counting that took place in the first year. Always start with the first quarter in the tax year and count to the quarter of sale.

When applying a modifying convention to personalty, you must look at the aggregate basis of all equipment subject to IRC Sec. 168 that is placed in service during the entire taxable year.

Remember: When calculating the 40%, residential rental property and nonresidential real property are **not** taken into account (IRC Sec. 168(d)(3)(B)).

The **aggregate basis** means all property subject to the general depreciation system (GDS) and the alternative depreciation system (ADS) (to be discussed in a later lesson), except residential rental property and nonresidential real property.

Property excluded from the 40% test includes the following (IRC Sec. 168(d)(3)(B)):

- Property placed in service and disposed of during the same year.
- Property depreciated under the units-of-production or income-forecast methods.
- Property expensed under IRC Sec. 179 (to be discussed in a later lesson).

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

6. MACRS applies to all tangible, depreciable property placed in service:

   a. After 1985.

   b. After 1986.

   c. In any year.

7. A building placed in service in November 2004 has gross rental income of $100,000. Of this 70% is from dwelling units. The shortest period this building can be depreciated for regular tax is:

   a. 27.5 years.

   b. 31.5 years.

   c. 39 years.

8. For 3-year and 5-year MACRS property:

   a. Use either the mid-quarter or half-year convention in the year of disposition.

   b. Do not take any depreciation in the year of disposition.

   c. Take a full year of depreciation in the year of acquisition.

9. During the year, a calendar-year taxpayer purchased equipment as follows:

Date	Asset	Cost
February 15	Copier	$150,000
March 3	Computer	$ 50,000
October 9	Office equipment	$200,000

   Which modifying convention applies to this equipment? (No first-year expensing or additional depreciation was taken.)

   a. Mid-quarter.

   b. Half-year.

   c. Mid-month.

10. $50,000 of 5-year property was acquired during the second quarter. $27,000 of 7-year property was acquired during the fourth quarter. IRC Sec. 179 expensing was not elected. In addition, the entity elected out of bonus depreciation. Which of the following is the modifying convention that applies for the year?

    a. Mid-quarter.

    b. Half-year.

    c. Mid-month.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

6. MACRS applies to all tangible, depreciable property placed in service: **(Page 15)**

   a. After 1985. [This answer is incorrect. In 1986, MACRS did not generally apply. Authoritative standards did not apply at this time.]

   b. After 1986. [This answer is correct. All tangible, depreciable property is subject to MACRS if placed in service after 1986, per the Internal Revenue Code.]

   c. In any year. [This answer is incorrect. MACRS applies only to tangible, depreciable property placed in service after a specific year.]

7. A building placed in service in November 2004 has gross rental income of $100,000. Of this 70% is from dwelling units. The shortest period this building can be depreciated for regular tax is: **(Page 19)**

   a. 27.5 years. [This answer is incorrect. Since the gross rental income from dwelling units is not 80%, the property cannot be treated as residential rental property and cannot be depreciated over 27.5 years.]

   b. 31.5 years. [This answer is incorrect. Since 80% of the rental income does not come from dwelling units, this building must be classified as nonresidential real property. Since it was placed in service after May 12, 1993, it cannot be depreciated over 31.5 years.]

   c. 39 years. [This answer is correct. Since 80% of the rental income does not come from dwelling units, this building must be classified as nonresidential real property. Since it was placed in service after May 12, 1993, the shortest period it can be depreciated for regular tax is 39 years (IRC Sec. 168(c)).]

8. For 3-year and 5-year MACRS property: **(Page 22)**

   a. Use either the mid-quarter or half-year convention in the year of disposition. [This answer is correct. If 3-year and 5-year MACRS property was treated as half-year property in the year of acquisition, it will be subject to the half-year convention in the year of disposition (IRC Sec. 168(d)(4)(A)).]

   b. Do not take any depreciation in the year of disposition. [This answer is incorrect. 3-year and 5-year MACRS property requires some depreciation to be claimed in the year of disposition (IRC Sec. 168(d)(4)(A)).]

   c. Take a full year of depreciation in the year of acquisition. [This answer is incorrect. 3-year and 5-year MACRS property does not permit a full year's depreciation in either the year of acquisition or the year of disposition (IRC Sec. 168(d)(4)(A)).]

9. During the year, a calendar-year taxpayer purchased equipment as follows:

Date	**Asset**	**Cost**
February 15	Copier	$150,000
March 3	Computer	$ 50,000
October 9	Office equipment	$200,000

Which modifying convention applies to this equipment? (No first-year expensing or additional depreciation was taken.) **(Page 23)**

a. Mid-quarter. [This answer is correct. The mid-quarter convention applies when over 40% of the aggregate property acquisition took place in the fourth quarter. This is the case in this scenario since $200,000 ÷ $400,000 = 50% (IRC Sec. 168(d)(3)).]

b. Half-year. [This answer is incorrect. You must test for the mid-quarter convention first. The half-year convention only applies if additions in the fourth quarter are not substantial (less than 40% of the total). The half-year convention does not apply since over 40% of the acquisition took place in the fourth quarter ($200,000 ÷ $400,000 = 50%) (IRC Sec. 168(d)(3)).]

c. Mid-month. [This answer is incorrect. The mid-month convention applies only to nonresidential and residential real property.]

10. $50,000 of 5-year property was acquired during the second quarter. $27,000 of 7-year property was acquired during the fourth quarter. IRC Sec. 179 expensing was not elected. In addition, the entity elected out of bonus depreciation. Which of the following is the modifying convention that applies for the year? **(Page 23)**

a. Mid-quarter. [This answer is incorrect. The mid-quarter convention applies when over 40% of the aggregate property acquisition took place in the fourth quarter. This is not the case here since $27,000 ÷ $77,000 = 35% (IRC Sec. 168(d)(3)).]

b. Half-year. [This answer is correct. You must test for the mid-quarter convention first. The half-year convention only applies if additions in the fourth quarter are not substantial (less than 40% of the total). The half-year convention applies since less than 40% of the acquisition took place in the fourth quarter ($27,000 ÷ $77,000 = 35%) (IRC Sec. 168(d)(3)).]

c. Mid-month. [This answer is incorrect. The mid-month convention applies only to nonresidential and residential real property.]

EXAMINATION FOR CPE CREDIT

Lesson 2

Determine the best answer for each question below. Then log onto our Online Grading Center at **OnlineGrading.Thomson.com** to record your answers.

3. MACRS applies to all tangible property placed in service after 1985.

   a. True.

   b. False.

   c. Do not select this answer choice.

   d. Do not select this answer choice.

4. Zingy Corp. purchased a $600,000 machine this year that has a class life of seven years and a salvage value of $40,000. What is the depreciable basis?

   a. $40,000.

   b. $500,000.

   c. $560,000.

   d. $600,000.

5. Josus, Inc. places a piece of real estate in service on January 1, 1998. The real estate is depreciated over 40 years. If the real estate were nonresidential property placed in service on January 1, 2008, the recovery period would be over how many years?

   a. 27.5.

   b. 39.

   c. 40.

   d. Do not select this answer choice.

6. Nonresidential real property placed in service from 1987 through May 12, 1993, is usually depreciated over _____________ years.

   a. 27.5.

   b. 31.5.

   c. 39.

   d. Do not select this answer choice.

7. Which of the following is an accurate statement?

   a. Under MACRS, buildings are recovered using the straight-line recovery method.

   b. MACRS requires taxpayers to reduce basis by expected salvage value.

   c. MACRS applies to both tangible and intangible property.

   d. MACRS allows the useful life of a property to be determined based on the facts and circumstances of its use.

8. Shrubbery, fences, roads and bridges have a depreciation life for regular tax (general depreciation system) of how long?

   a. 15 years.

   b. 20 years.

   c. 27.5 years.

   d. 31.5 years.

9. Which of the following applies to nonresidential real property?

   a. The convention is half-year.

   b. The convention is mid-month.

   c. The depreciation method is 200%-declining-balance method.

   d. The recovery period is 27.5 years.

10. Which of the following conventions is allowed when IRC Sec. 168 applies to residential rental property?

    a. Half-year convention.

    b. Mid-quarter convention.

    c. Mid-month convention.

    d. Mid-year convention.

11. This year on January 1, Joan acquired a $300,000 rental house (residential rental property); $100,000 of the cost was allocated to the land. What is the depreciation expense for this year?

    a. $6,086.

    b. $6,349.

    c. $6,970.

    d. $7,273.

Lesson 3: Allowable Depreciation Methods and the IRS Optional Tables

Introduction

In the previous lessons, you learned to determine a property's applicable recovery period and modifying convention to recover the cost of the property under MACRS. As mentioned in those lessons, you also need to determine a property's applicable depreciation method to recover costs. In this lesson, you will learn about allowable depreciation methods and how to use the IRS optional tables to replace the manual calculation of double-declining-balance depreciation. Then you will pull all the pieces together into a calculation of cost recovery under MACRS using the general depreciation system (GDS).

Learning Objectives

Completion of this lesson will enable you to:

- Identify allowable depreciation methods.
- Utilize the IRS optional tables and those allowed in subsequent years.

Allowable Depreciation Methods

The applicable depreciation method for regular tax for 3-year, 5-year, 7-year and 10-year property recovery classes is the 200%-declining-balance method, switching to the straight-line method in the taxable year that maximizes the depreciation allowance.

Under the declining-balance method, the rate remains the same, but it is applied to the "book value" each year. As the remaining basis decreases, so does the annual depreciation.

If you have trouble following the math, take heart. There are optional tables that simplify the actual calculation as long as you have mastered the basics of the following:

- Recovery period
- Required modifying convention
- Depreciation method allowed

Example 1: Qualified rent-to-own property that costs $100,000 is placed in service in June of the current year. This is the only asset placed in service by the taxpayer during the year. The taxpayer does not elect IRC Sec. 179 expensing (discussed later), or use additional first-year depreciation.

Recovery Period: This is on the list of 3-year assets discussed earlier.

Required Modifying Convention: There is no property placed in service in the fourth quarter; therefore, the half-year convention will apply (see Optional IRS Generated Depreciation

Percentages, 3-Year MACRS Property, Subject to Half-Year or Mid-Quarter Convention, available in Table A-8).

Depreciation Method Allowed: In the absence of the election of an alternative method (discussed later), the method for all 3-year, 5-year, 7-year and 10-year property is the 200%-declining-balance method.

For each property that is depreciated, you need to determine the following:

- Basis
- Method
- Modifying convention

Year	Basis	Method	Modifying Convention	Depreciation
1	$100,000	⅓ × 2	Half-year	$33,333
2	$66,667 ($100,000 – $33,333)	⅓ × 2	N/A[1]	44,445
3	$22,222 ($100,000 – $77,778)	⅔[2]	N/A[1]	14,815
4	$22,222	⅓[2]	N/A[1]	7,407

[1] No modifying convention except in year acquired or disposed of.

[2] A switch to the straight-line method is made in Year 3, when the remaining basis is $22,222.

There are three half-years remaining in the depreciation period:

- Two half-years in Year 3
- One half-year in Year 4

In Year 3, the depreciation is calculated by dividing $22,222 by three half-years and multiplying by two half-years to obtain the depreciation deduction.

Remember: It takes an extra year to recover the full cost of property since each of the conventions ensures that there is not a full 12 months of recovery in the first year.

The applicable depreciation method for regular tax for 15-year and 20-year property recovery classes is the 150%-declining-balance method, switching to the straight-line method in the taxable year that maximizes the depreciation allowance.

These calculations are similar to the 200% ones given previously, except depreciation is increased by 50% instead of 100%.

If the property in the previous example was 15-year property, the first year's recovery would be calculated as follows:

Year	Basis	Method 150% DB	Annual Amount	Modifying Convention	Depreciation
1	$100,000	1 ÷ 15 × 1.5 = 0.10	$10,000	Half-year	$5,000

The applicable depreciation method for residential rental and nonresidential real property is the straight-line method.

As a quick review, if the property in the previous example was nonresidential real estate placed in service in June of this current year, the first year's recovery would be calculated as follows:

Year	Basis	Method Straight-line	Annual Amount	Modifying Convention	Depreciation
1	$100,000	1 ÷ 39 = 0.02564	$2,564	(7 – 0.5) ÷ 12 = .54167	$1,389

No other depreciation method may be used for property subject to the general depreciation system (regular tax) **unless** the taxpayer makes an irrevocable election (as set out by IRC Sec. 168(b)(5)) to use, for a particular recovery class of property, either:

- The straight-line method, or
- The 150%-declining-balance method.

If the taxpayer chooses to elect either the straight-line or 150%-declining-balance method, the election applies to **all** property within a recovery class placed in service in that taxable year (IRC Secs. 168(b)(2)(C) or 168(b)(3)(D), and 168(b)(5)).

Note: The election to depreciate using either the straight-line or 150%-declining-balance method is made on a class-by-class **and** a year-by-year basis (IRC Sec. 168(b)(5)).

Example 2: During the year, a calendar-year taxpayer places the following property in service:

Date	Asset Class	Cost
May 15	5-year	$100,000
June 30	3-year	$ 90,000
September 19	5-year	$350,000

There is no property placed in service in the fourth quarter; therefore, the half-year convention will apply to all of these assets regardless of the depreciation method selected.

Example 3: Under this set of facts, the taxpayer could elect to do the following:

- Use the 200%-declining-balance method for all three assets.
- Use the 150%-declining-balance method for **both** of the 5-year recovery properties and the straight-line method or 200%-declining-balance method for the 3-year property.
- Use the 150%-declining-balance method for the 3-year property and the straight-line method or 200%-declining-balance method for **both** of the 5-year recovery properties.
- Use the 150%-declining-balance method for all three assets.
- Use the straight-line method for all three assets.

Reminder: There is no property placed in service in the fourth quarter; therefore, the half-year convention will apply to all of these assets regardless of the depreciation method selected.

Using the IRS Optional Tables

In this lesson, we will quickly review the basics, then we will learn how to use the IRS optional tables to replace the manual calculation of double-declining-balance depreciation.

MACRS property with a recovery period for regular tax purposes (general depreciation system) of 3, 5, 7 and 10 years will be depreciated using:

- The 200%-declining-balance method,
- Switching to the straight-line method for the first taxable year for which use of the straight-line method will yield a larger allowance.

MACRS ignores salvage value.

The half-year or mid-quarter modifying convention applies in both the year of acquisition and of disposition (see Optional IRS Generated Depreciation Percentages, 3-Year MACRS Property, Subject to Half-Year or Mid-Quarter Convention, available in the appendix).

When an asset is purchased and sold in the same year, no depreciation is allowed for that year.

In lieu of the 200%-declining-balance method, the taxpayer may elect to use the straight-line method **or** the 150%-declining-balance method.

An election out of the 200%- or 150%-declining-balance method is:

- Made on a class-by-class basis (applies to **all** property in that recovery class placed in service during the tax year),
- Made on a year-by-year basis, and
- Irrevocable once made.

Using the IRS tables available in the appendices, we will now learn how to use the IRS table percentages for depreciation.

Important: When you use the tables, you do **not** decline or reduce the original cost. The IRS has reduced the depreciation percentage instead. That way, you do not have to subtract accumulated depreciation from the cost basis before multiplying (less work and less math errors by the taxpayer).

We will practice using the tables with an example from the last lesson. The mid-quarter convention applies, so you will need Tables A-2, A-3, A-4, and A-5 (Appendices A2, A3, A4, and A5) to see where the percentages are coming from.

Example 4: During the year, a calendar-year taxpayer places the following property in service:

Date	Asset Class	Cost
May 15	5-year	$100,000
September 30	7-year	$ 90,000
November 19	7-year	$350,000

There is property placed in service in the fourth quarter **and** the fourth-quarter items are greater than 40% of the total ($350,000 ÷ $540,000 = 64.8%). We have two recovery classes, but we will need three separate depreciation percentages to calculate depreciation.

Example 5: There are three property groupings, as shown. The number of the table where you can find the percentages for each row is listed within the parentheses. Please take the time to make sure you know where each of the numbers came from before you move on.

Property	Year 1	Year 2	Year 3	Year 4
May 15, 5-year, 2nd quarter (A-3)	25.00%	30.00%	18.00%	11.37%
Sep. 30, 7-year, 3rd quarter (A-4)	10.71%	25.51%	18.22%	13.02%
Nov. 19, 7-year, 4th quarter (A-5)	3.57%	27.55%	19.68%	14.06%

As long as there are no early dispositions, depreciation for each asset is just the original cost basis multiplied by the correct percentage. The modifying convention has already been applied to the table percentage for Year 1.

The cost recovery associated with the September 30 addition in Year 1 is $9,639 ($90,000 × .1071), and in Year 3 is $16,398 ($90,000 × .1822). In the next lesson, we will use the tables with dispositions.

Tables and Basis Adjustments

Rules Covering Use of the Tables

- The percentage tables cannot be used for a short tax year.
- Once used, the tables must be used for the entire recovery period, unless there are adjustments to the basis of property for reasons **other than**:
    - Depreciation allowed or allowable, or
    - An addition or improvement to the property that is depreciated as a separate item of property (discussed later in this lesson).

Adjustments to basis caused by casualty losses require the taxpayer to stop using the tables. If there is a casualty, the taxpayer declines basis for the casualty and accumulated depreciation and begins manual calculations.

Example 6: On October 26 of last year, Sandra Elm bought and placed in service in her business an item of 7-year property. Her unadjusted basis was $10,000. She figured her deduction using the percentages in Table A-5. She did not elect IRC Sec. 179 expensing. For Year 1, her depreciation was $357 ($10,000 × .0357).

In July of Year 2, her property was vandalized, and Sandra had a deductible casualty loss of $3,000. Because she must adjust her property's basis for the casualty loss, she can no longer use the percentage tables. Her adjusted basis before figuring her depreciation is $6,643 ($10,000 less depreciation of $357 and the casualty loss of $3,000).

Her depreciation for Year 2, calculated without the percentage tables, is $1,898 ($6,643 × 1/7 × 2). To calculate depreciation for Year 3, Sandra will have to decline the basis to $4,745 ($6,643 – $1,898) and multiply by (1/7 × 2) or 28.57%.

(IRS Pub. 946, adapted)

Additions and improvements to any property are treated as separate property items for purposes of computing depreciation. The recovery period for any addition or improvement to property begins in the **later** of (Rev. Proc. 87-57, 1987-2 CB 687):

- The taxable year in which the addition or improvement is placed in service, or
- The taxable year in which the property, with respect to which such addition or improvement was made, is placed in service.

The applicable **depreciation method, recovery period** and **convention** must be determined for the addition.

Leasehold Improvements

Sometimes a taxpayer leases property and makes improvements to it to adapt the property to its business needs. These are generally called leasehold improvements.

A lessee is treated as an owner for purposes of determining MACRS depreciation for lessees' improvements and for buildings erected on leased premises.

Leasehold improvements made to **residential** rental property must be depreciated over their recovery period of 27.5 years even if the lease term is shorter. Any remaining unrecovered basis in the improvements would be deducted as an abandonment loss if the lease is terminated before the end of the 27.5 years.

Prior to October 22, 2004, a lessee must depreciate leasehold improvements over their recovery period even if the lease term is shorter. Any remaining unrecovered basis in the improvements is deducted as an abandonment loss when the lease is terminated.

Leasehold improvements made by the lessor also follow this rule. If the improvements are irrevocably disposed of or abandoned by the lessor at the termination of the lease, the lessor is entitled to an abandonment loss for the unrecovered basis (IRC Sec. 168(i)(8)).

Note: The American Jobs Creation Act of 2004 created a 15-year recovery period for some nonresidential leasehold improvements. This rule was supposed to expire on January 1, 2006, but it has been extended twice. It now applies through December 31, 2009. Watch to see if it is extended yet again.

Note: A leasehold improvement that is not a structural component can be separately depreciated over a shorter recovery period under the MACRS cost segregation rules. This would include things like a removable partition, for example.

Current Rule for "Qualified" Nonresidential Leasehold Improvements

Qualified leasehold improvements made to nonresidential real property (39-year recovery property) placed in service after October 22, 2004, and before January 1, 2010, are recovered over 15 years using straight-line depreciation.

Improvements to residential rental property (27.5-year recovery property) do **not** qualify for this treatment.

This provision is not elective. However, if the MACRS alternative depreciation system (ADS) is elected, the recovery period would be 39 years. Regardless of whether ADS is elected, the applicable convention is the half-year convention **unless** the mid-quarter convention applies. Under either recovery period, the leasehold improvements would be included in the costs used to test if the mid-quarter convention applies. IRC Sec. 168(k)(3)

Note: ADS is the only option other than the GDS rules that have been discussed so far that is available under MACRS. We will discuss this method in detail in a later lesson. For now, it is enough to note that ADS provides longer lives and slower methods.

Definition of "Qualified"

Qualified leasehold improvement property is any improvement to an interior portion of **nonresidential** real property if all of the following requirements are met:

- The improvement is made under or pursuant to a lease by the lessee, any sublessee, or the lessor.
- The lease is not between related persons.
- The building (or portion that the improvement is made to) is occupied exclusively by the lessee or sublessee.
- The improvement is a structural component.
- The improvement is placed into service more than three years after the date that the building was first placed into service.

Excluded from "Qualified"

Expenditures for the following are not qualified leasehold improvement property:

- Enlargement of the building

- Elevators and escalators
- Structural components that benefit a common area
- Internal structural framework

Note: A common area is one used by different lessees of a building, such as stairways, hallways, lobbies, common seating areas, interior and exterior pedestrian walkways and pedestrian bridges, loading docks and areas and restrooms.

Temporary Regulation Section 1.168(k)-1T(c), relating to additional first-year depreciation, should apply to help determine whether the leasehold improvement qualifies for the 15-year recovery period. These rules will be briefly covered in a later lesson.

Restrictions on Transactions between Related Parties

The lease may not be between related persons. This includes members of an affiliated group and persons with a relationship described in IRC Sec. 267(b) with an “80% or more” ownership requirement in place of “more than 50%” that generally applies.

Transfer of Ownership

A subsequent purchaser of a building with 15-year leasehold improvements that were placed in service by the prior owner must recover the entire purchase price over 39 years. This rule does not apply to the new owner if transfer of ownership occurred by reason of:

- The lessor’s death,
- A corporate acquisition in transaction involving the liquidation of subsidiaries or certain qualified reorganizations,
- A mere change in the form of conducting the trade or business so long as the property is retained in the trade or business as qualified leasehold improvement property and the taxpayer retains a substantial interest,
- A like-kind exchange, or
- An involuntary conversion.

IRC Sec. 168(e)(6)(B)(iv) also excludes most transactions where the basis of the leasehold improvement property in the hands of the subsequent owner is determined by reference to its basis in the hands of the original lessor. This would include transfers to a partnership and a qualifying IRC Sec. 351 transfer.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

11. Which of the following is the applicable depreciation method to be used for the general depreciation system (GDS) for residential rental property?

    a. Straight-line method for all years.

    b. 200%-declining-balance method for all years.

    c. 150%-declining-balance method.

12. Which of the following is a characteristic of 15-year and 20-year property?

    a. The 200%-declining-balance method is applicable.

    b. The half-year or mid-quarter convention applies in the year of acquisition only.

    c. The taxpayer may elect to use the straight-line method of depreciation.

13. Which of the following statements is accurate concerning the optional percentage tables for MACRS provided by the IRS?

    a. Adjustments to basis caused by casualty losses require the taxpayer to stop using the tables.

    b. The taxpayer must stop using the percentage tables if there is an addition or improvement to the property that is depreciated as a separate item of property.

    c. Taxpayers can decide each year whether or not to use the optional tables for MACRS provided by the IRS.

14. A 10-year property was placed in service in 2006. In 2010, an improvement was made to the 10-year property. The recovery period for the improvement began in:

    a. 2006.

    b. 2010.

    c. Whichever year the taxpayer elects.

15. Andy Cohen signed a 10-year lease on January 1, 2008, on new office space in Seattle. On December 30, 2009, Andy made $100,000 of qualifying leasehold improvements. Andy can write off the leasehold improvements over:

    a. 39 years, the MACRS life.

    b. 10 years, the lease life.

    c. 15 years.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

11. Which of the following is the applicable depreciation method to be used for the general depreciation system (GDS) for residential rental property? **(Page 35)**

    a. Straight-line method for all years. [This answer is correct. The applicable depreciation method for residential rental property is the straight-line method (Rev. Proc. 87-57, 1987-2 CB 687).]

    b. 200%-declining-balance method for all years. [This answer is incorrect. The 200%-declining-balance method for all years is not allowed as a depreciation method for any asset placed in service after December 31, 1986 (Rev. Proc. 87-57, 1987-2 CB 687).]

    c. 150%-declining-balance method. [This answer is incorrect. The 150%-declining-balance method is not the applicable depreciation method to be used for the GDS for residential rental property (Rev. Proc. 87-57, 1987-2 CB 687).]

12. Which of the following is a characteristic of 15-year and 20-year property? **(Page 35)**

    a. The 200%-declining-balance method is applicable. [This answer is incorrect. Both 15-year and 20-year property can use the 150%-declining-balance method, not the 200%-declining-balance method (Revised IRC Sec. 168(b)(2)).]

    b. The half-year or mid-quarter convention applies in the year of acquisition only. [This answer is incorrect. The half-year or mid-quarter convention applies in both the year of acquisition and the year of disposition (Revised IRC Sec. 168(d)(4)(A)).]

    c. The taxpayer may elect to use the straight-line method of depreciation. [This answer is correct. While the default for 15- and 20-year property is the 150%-declining-balance method, the taxpayer may elect to use the straight-line method of depreciation for either or both classes per the Internal Revenue Code.]

13. Which of the following statements is accurate concerning the optional percentage tables for MACRS provided by the IRS? **(Page 37)**

    a. Adjustments to basis caused by casualty losses require the taxpayer to stop using the tables. [This answer is correct. If there is a casualty loss, the taxpayer reduces basis for the casualty loss and accumulated depreciation and begins manual calculations.]

    b. The taxpayer must stop using the percentage tables if there is an addition or improvement to the property that is depreciated as a separate item of property. [This answer is incorrect. Once used, the tables must be used for the entire recovery period unless there are adjustments to the basis of property for reasons other than depreciation allowed or allowable or an addition or improvement to the property that is depreciated as a separate item of property.]

c. Taxpayers can decide each year whether or not to use the optional tables for MACRS provided by the IRS. [This answer is incorrect. Once used, the tables must be used for the entire recovery period unless there are adjustments to the basis of property for reasons other than depreciation or improvements depreciated as a separate item.]

14. A 10-year property was placed in service in 2006. In 2010, an improvement was made to the 10-year property. The recovery period for the improvement began in: **(Page 38)**

a. 2006. [This answer is incorrect. The recovery period for an improvement is the later of: the date the improvement is placed in service or the date the asset was placed in service. Therefore, 2006 is not the later date since the improvement was not made until 2010 (Rev. Proc. 87-57, 1987-2 CB 687).]

b. 2010. [This answer is correct. Since the 10-year property was placed in service in 2006 and the addition was not completed until 2010, the later date controls (Rev. Proc. 87-57, 1987-2 CB 687).]

c. Whichever year the taxpayer elects. [This answer is incorrect. The taxpayer does not get to choose. According to IRS regulations, recovery begins on the later of: the date the improvement is placed in service or the date the asset was placed in service.]

15. Andy Cohen signed a 10-year lease on January 1, 2008, on new office space in Seattle. On December 30, 2009, Andy made $100,000 of qualifying leasehold improvements. Andy can write off the leasehold improvements over: **(Page 39)**

a. 39 years, the MACRS life. [This answer is incorrect. The taxpayer must depreciate most leasehold improvements over their class lives even if the lease term is shorter. However, if there are qualifying leasehold improvements, Andy can recover these costs over a shorter time frame as provided in the tax extenders and AMT Relief Act of 2008.]

b. 10 years, the lease life. [This answer is incorrect. The taxpayer must depreciate leasehold improvements over their class lives even if the lease term is shorter.]

c. 15 years. [This answer is correct. The taxpayer must depreciate leasehold improvements over their class lives even if the lease term is shorter. However, if there are qualifying leasehold improvements, Andy can recover these costs over 15 years, using straight-line and mid-quarter convention. The remaining basis of unamortized leasehold improvements that are left behind when the lease terminates is deductible as an abandonment loss (IRC Sec. 168(i)(8)(A)).]

EXAMINATION FOR CPE CREDIT

Lesson 3

Determine the best answer for each question below. Then log onto our Online Grading Center at **OnlineGrading.Thomson.com** to record your answers.

12. Denver Inc. purchased a $20,000, 5-year asset in August of the current year. This was the only asset the company placed in service during the year. The straight-line method was elected. Limited expensing is **not** elected and additional first-year depreciation is **not** available. What is the depreciation for the first year?

    a. $0.

    b. $1,000.

    c. $2,000.

    d. $2,500.

13. A fifteen year asset is placed into service in June of the current year. The total cost of the asset is $150,000 and it is the only asset the taxpayer places into service during the current tax year. The taxpayer does **not** elect IRC Sec. 179 expensing and elects out of bonus depreciation. What is the depreciation in Year 1?

    a. $7,500.

    b. $10,000.

    c. $15,000.

    d. $20,000.

14. The cost of an addition:

    a. Is added to the original cost of the asset to which it relates and depreciated over the remaining life of the original asset.

    b. May have a different beginning recovery period than the original property.

    c. Is considered an intangible asset and is depreciated under the straight-line method.

    d. Do not select this answer choice.

Lesson 4: More on Using the IRS Optional Tables

Introduction

In this lesson, you will learn to use the IRS optional tables to calculate the recovered cost of property under MACRS with early dispositions of real, mid-quarter and half-year properties. We will also cover how to use a general asset account, calculate gain or loss on dispositions and learn when items must be removed from a GAA.

Learning Objectives

Completion of this lesson will enable you to:

- Utilize the IRS optional tables with early disposition of real, mid-quarter and half-year properties.
- Utilize a general asset account, calculate gain or loss on dispositions and identify items to be deleted from a GAA.

Using the IRS Optional Tables with Early Dispositions of Real Property

First, a quick review of what you should know about MACRS at this point.

- MACRS **must be used** (few exceptions) for tangible assets placed in service after 1986.
- An economic useful life is not considered. Property is placed in classes.
- Salvage value does not apply.
- Rental property is recovered on a straight-line basis, using a mid-month convention.
- Residential real estate uses 27.5 years.
- Nonresidential real property uses a 39-year recovery period if placed in service on or after May 13, 1993, or a 31.5-year recovery period if placed in service from 1987 through May 12, 1993.
- MACRS classifies all personal property and some real property into six additional categories as follows:

Property Category	Recovery Period (General Depreciation System to Be Used for Regular Tax)	Default Method Declining-balance Method (DB)	Alternative Methods Declining-balance Method (DB)
3-year	3 years	200%-DB	150%-DB or straight-line
5-year	5 years	200%-DB	150%-DB or straight-line
7-year	7 years	200%-DB	150%-DB or straight-line
10-year	10 years	200%-DB	150%-DB or straight-line
15-year	15 years	150%-DB	straight-line
20-year	20 years	150%-DB	straight-line

- The mid-quarter convention will apply to all personal property placed in service during the year if more than 40% of the total property that is placed in service during the tax year was placed in service during the last three months.
- If the mid-quarter convention does not apply, equipment uses a mid-year convention.
- How to use the IRS optional tables in Year 1 and subsequent years when there is no disposition.

A modifying convention must be applied in **both** the year of acquisition and the year of disposition. Allowable depreciation in the taxable year in which a convention applies is a fraction of the amount of depreciation that would be allowable for a full taxable year (12 full months) (IRC Sec. 168(d)(4)(A)).

In a year of early disposition, the same modifying convention that was used at acquisition must be applied to the table percentage.

The examples that follow require using Tables A-6, A-7, and A-7a (All tables are located in the appendix after the glossary.)

Remember: When an asset is purchased and sold in the same year, no depreciation is allowed for that asset (Reg. Sec. 1.168(d)-1(b)6).

If the property was mid-month in the year of acquisition, it uses the mid-month convention at disposition.

- This is the applicable convention to be used in computing depreciation for nonresidential and residential rental property.
- When a building is purchased, start with the month of purchase, count the remaining months in the tax year, and subtract 0.5.
- When a building is sold, do the same calculation in reverse. Start with January and count to the month the building is sold. Then, to apply the modifying convention, subtract 0.5.
- If a building is sold in December, take 11.5 months of depreciation. (There are 12 months, including December, that the building is held and the convention allows only half (0.5) of a month's depreciation for the month of sale.)

Example 1: Tom purchased a new office building on November 15, 1995, for $4.4 million. On March 1 of the current year, the building was sold; $400,000 of the original purchase price was allocated to the land.

For the year of purchase, the manual calculation in Lesson 3 was $12,821 (($4,000,000 ÷ 39 years) × (1.5 ÷ 12)).

Using Table A-7a, we get $12,840 ($4,000,000 × .00321). Go to the column labeled "11" (placed in service in November, the 11th month) and row 1.

You did not need to make an explicit adjustment for the modifying convention since the table did the math, but you did need to know to go to the column labeled "11."

Using the table percentage gives a larger number than the manual calculation, but for $4 million of cost, it is pretty close. The IRS does not care whether you do manual calculations or use the tables.

Note: Since .321% is less than 1%, make sure you enter .00321 if you are going to multiply with a hand calculator.

In our example, Tom sold the building on March 1. For the manual calculation, we count from January to the month of sale (March) and subtracted 0.5. So Tom was entitled to 2.5 months of depreciation in the year of sale or $21,368 (($4,000,000 ÷ 39 years) × (2.5 ÷ 12)).

The tables cannot account for every possible disposition alternative, so the mid-month modifying convention must be applied to the full-year percentage taken from the table. The table calculation is $21,367 ($4,000,000 × .02564 × (2.5 ÷ 12)).

Since buildings are recovered on a straight-line basis, the advantages of using the table are fairly limited. The tables do save some math in the first year, since you do not need to multiply by the modifying convention.

We will do one more example using residential property, and then we can move on to other recovery classes.

Example 2: Residential real property is placed in service in January 2001. The purchase price was $1.4 million. On May 1, 2006, the building is sold; $400,000 of the purchase price was allocated to the land.

Cost recovery in Year 1:	$34,850	($1,000,000 × .03485)
Cost recovery in Years 2–5:	$36,360	($1,000,000 × .03636)
Cost recovery in Year 6:	$13,635	($1,000,000 × .03636 × 4.5 ÷ 12)

The percentages come from Table A-6. Make sure you know how to determine the correct percentages before you go on.

Using the IRS Optional Tables with Early Dispositions of Mid-quarter Property

For this lesson, we will assume that the taxpayer does not deduct limited expensing or additional first year depreciation (both discussed in Lesson 6).

If the property was mid-quarter in the year of acquisition, use the mid-quarter convention at disposition.

- The mid-quarter convention will apply to all personal property placed in service during the year if a substantial percentage (greater than 40%) of the total property that is placed in service during the tax year was placed in service during the last **three** months.
- To apply the mid-quarter convention in the year the property is disposed of, multiply the depreciable basis of the property by the depreciation percentage from the table, then multiply by the following fraction: (x – 0.5)/4 (where x is the number of quarters the property was in service.

Reminder: All property from the six personalty classes is combined to determine if the mid-quarter convention applies.

To apply the mid-quarter convention in a year of disposition, simply follow the rule for buildings, but count quarters instead of months and subtract 0.5 quarter. Start with the first quarter and count to the quarter the equipment was sold. Then, subtract 0.5 quarter.

- Property disposed of in the first quarter is entitled to (1 – 0.5)/4, or 12.5% of the full year's depreciation amount.
- Property sold in the second quarter is entitled to (2 – 0.5)/4, or 37.5% of the full year's depreciation amount.
- Property disposed of in the third quarter is entitled to (3 – 0.5)/4, or 62.5% of the full year's depreciation amount.
- Property sold in the fourth quarter is entitled to (4 – 0.5)/4, or 87.5% of the full year's depreciation amount.

If the taxpayer sells mid-quarter equipment in October, November, or December, the taxpayer will get 3 5/4 or 87.5% of the full year's depreciation. (There are four quarters. These months fall in the fourth quarter, and the mid-quarter convention allows only one-half of a quarter's depreciation for the quarter of sale.)

The counting of quarters in the year of sale is independent of the counting that took place in the first year. Always start with the first quarter for the year of sale and count to the quarter of sale.

You determine which depreciation table to use in year 1. **You never leave that table.** In a year of disposition, you take the percentage from the table for the correct year and apply the mid-quarter modifying convention to that percentage.

Example 3: During the year, a calendar-year taxpayer places the following property in service:

Date	Asset Class	Cost
February 15	5-year	$100,000
October 9	7-year	$350,000

There is property placed in service in the fourth quarter **and** the fourth-quarter items are greater than 40% of the total ($350,000 ÷ $450,000 = 77.8%). Therefore, **all** of the property is treated as mid-quarter property. Depreciation in the year placed in service and the year of sale will be adjusted based on the number of quarters the property is in service. Use Table A-2 for the 5-year property and Table A-5 for the 7-year property for **all** years, even if there is an early disposition.

First, we will calculate the cost recovery of the February property in Year 1: $35,000 ($100,000 × .35)—the modifying convention is built into the table.

Then we will calculate the cost recovery of the February property in Year 2, assuming that we hold it the full year: $26,000 ($100,000 × .26).

Then we will calculate the cost recovery of the February property in Year 2, assuming that we sell it in May: $9,750 ($100,000 × .26 × (1.5 ÷ 4)), ($26,000 × .375 = $9,750).

Now we will calculate the cost recovery of the February property in Year 2, assuming that we sell it in November: $22,750 ($100,000 × .26 × (3.5 ÷ 4)), ($26,000 × .875 = $22,750).

Note: In Year 2, we always start with 26% in Table A-2. If there is a disposition, we adjust by applying the mid-quarter modifying convention to the 26%.

Now we will calculate the cost recovery of the October property using Table A-5 for 7-year property: $12,495 ($350,000 × .0357).

Then we will calculate the cost recovery of the October property in Year 2, assuming that we hold it the full year: $96,425 ($350,000 × .2755). (For Year 1, the modifying convention is built into the table percentage.)

Then we will calculate the cost recovery of the October property in Year 2, assuming that we sell it in January: $12,053 ($350,000 × .2755 × .125), first-quarter adjustment: (1 – 0.5) ÷ 4 = 0.5 ÷ 4 = .125.

Now we will calculate the cost recovery of the October property in Year 2, assuming that we sell it in September: $60,266 ($350,000 × .2755 × .625), third-quarter adjustment: (3 – 0.5) ÷ 4 = 2.5 ÷ 4 = .625.

Note: In Year 2, we always start with 27.55% from Table A-5. If there is a disposition, we adjust by applying the mid-quarter modifying convention to the 27.55%.

Using the IRS Optional Tables with Early Dispositions of Half-year Property

For this lesson, we continue to assume that the taxpayer does not deduct limited expensing or additional first year depreciation (both discussed in Lesson 6).

If property is subject to the half-year convention in the year of acquisition, the modifying convention at disposition is also half-year.

- If no personalty is placed in service in the fourth quarter, the half-year convention will apply to all assets (except buildings) placed in service during the year.
- If a substantial percentage (greater than 40%) of the total equipment is **not** placed in service during the last three months, the half-year convention will apply to all assets (except buildings) placed in service during the year.
- It does not matter when the half-year property is disposed of during the year. Half-year property sold on January 1 and half-year property sold on December 31 are both entitled to one-half of the full year's depreciation calculation.

Note: All property from the six equipment classes is combined to determine if the half-year convention applies.

Example 4: During the year, a calendar-year taxpayer who does not elect limited expensing or additional depreciation places the following property in service. Additional first-year depreciation does not apply.

Date	Asset Class	Cost
February 15	5-year	$100,000
September 3	7-year	$ 50,000

Since none of the property was placed in service in the last quarter (October, November, December), all of the property is half-year property. Depreciation in the year placed in service and the year of sale will be one-half of the full year's calculation. Use Table A-1.

First, we will calculate the cost recovery of the February property in Year 1:

Cost recovery in Year 1: $20,000 ($100,000 × .20)

Then we will calculate the cost recovery of the February property in Year 2, assuming that we hold it the full year:

$32,000 ($100,000 × .32)

Then we will calculate the cost recovery of the February property in Year 2, assuming that we sell it in May:

$16,000 ($100,000 × .32 × 0.5)

Now we will calculate the cost recovery of the February property in Year 2, assuming that we sell it in November:

$16,000 ($100,000 × .32 × 0.5)

Note: In Year 2, we always start with 32% in Table A-1. If there is a disposition, we adjust by multiplying the 32% by one-half, regardless of when the disposition takes place during the year.

Now we will calculate the cost recovery of the September, 7-year property in Year 1:

Cost recovery in Year 1: $7,145 ($50,000 × .1429)

Then we will calculate the cost recovery of the September property in Year 2, assuming that we hold it the full year:

$12,245 ($50,000 × .2449)

Then we will calculate the cost recovery of the September property in Year 2, assuming that we sell it in January:

$6,123 ($50,000 × .2449 × 0.5)

Now we will calculate the cost recovery of the September property in Year 2, assuming that we sell it in September:

$6,123 ($50,000 × .2449 × 0.5)

Note: In Year 2, we always start with 24.49% from Table A-1. If there is a disposition, we adjust by multiplying the 24.49% by one-half, regardless of when the disposition takes place during the year.

Using General Asset Accounts

In this section you will determine how to use a general asset account, calculate gain or loss on dispositions, and learn when items must be removed from a GAA.

Taxpayers can group separate properties into one or more general asset accounts (GAA). All the properties in a GAA are depreciated as a single item of property. The use of GAA can make recordkeeping easier since only one depreciation calculation needs to be done for the grouped properties.

Dispositions of property included in a GAA follow special rules that must be carefully reviewed before deciding that a GAA is a good choice for a taxpayer. An early disposition of an asset included in a general asset account will usually cause the entire amount realized to be recognized as ordinary income while the remaining basis in the asset continues to be recovered over time. Furthermore, certain dispositions can require the recipient to use a GAA for the acquired assets.

In this lesson we will discuss the basics of using GAA to calculate depreciation and how to deal with dispositions that do not terminate the GAA election. You can consult IRS Pub. 946, “How to Depreciate Property,” for more information.

Each GAA must include only properties placed in service in a single year that have the same:

- Asset class,
- Recovery period,
- Depreciation method, and
- Convention—there must be a separate GAA for each quarter of mid-quarter property and each month of mid-month property.

Note: Automobiles and light trucks subject to depreciation limits must be grouped into separate GAAs. Property that is used in both a personal and depreciable capacity cannot be included in a GAA.

Example 5: Make & Sell Corporation set up a GAA for 10 machines that were properly classified as mid-year, 5-year property recovered under the 200%-declining-balance method. One of the machines cost $82,000 and the rest cost a total of $18,000. To make our calculations easier, assume that Make & Sell did not claim the IRC Sec. 179 deduction on the machines and additional first year depreciation was not available.

The depreciation allowance for Year 1 would be $20,000 ($100,000 × .20). The depreciation reserve account at the end of Year 1 would be $20,000. Over the next five years, depreciation would continue to be calculated on the full $100,000 even if some of the equipment was sold, unless the property is removed from the GAA. IRS Pub. 946, adapted.

Disposing of GAA Property That Is Not Removed from the GAA

Property in a GAA is considered disposed of if it is:

- Permanently withdrawn from use in an activity that gives rise to depreciation,
- Transferred to a supplies, scrap or similar account, or
- Sold, exchanged, retired, physically abandoned or destroyed.

The following rules apply when there is a disposition of property included in a GAA and the property is not removed from the GAA. After we cover the mechanics of this provision, we will discuss when the property is removed from the GAA before gain or loss is calculated. Once again, the most important thing to understand is that committing to a GAA will mean that you do not get to recover basis at the time of an early disposition and you continue to depreciate the cost of the property as if it was still in service.

In the case of a disposition, the following rules apply:

- Neither the depreciable basis nor the depreciation reserve account of the GAA is affected when there is an asset disposition.
- Depreciation is calculated as if the disposition had not occurred.
- The disposed property is treated as having an adjusted basis of zero.
- The amount realized on the disposition is treated as ordinary income up to:
  - The unadjusted depreciable basis of the GAA, plus
  - Any expensed costs for property in the GAA that are subject to recapture as depreciation, minus
  - Any amount previously recognized as ordinary income from the disposition of other property from the GAA.

Example 6: In February of Year 2, Make & Sell sells the $82,000 machine to an unrelated person for $90,000. The machine is treated as having an adjusted basis of zero. On that tax return, Make & Sell recognizes the $90,000 amount realized as ordinary income because the amount realized is not more than the GAA's unadjusted depreciable basis ($100,000) plus any expensed cost for property in the GAA ($0), minus any amounts previously recognized as ordinary income because of dispositions of other property from the GAA ($0).

The cost recovery deduction for Year 2 would be based on the full $100,000, using the second-year recovery percentage. It would be $32,000 ($100,000 × .32). The depreciation reserve account at the end of Year 2 would be $52,000.

(IRS Pub. 946, adapted)

In Year 3, Make & Sell sold the remaining machines in the GAA for $11,000 and did not make an election to terminate the GAA. Make & Sell would recognize $10,000 as ordinary income. This is the GAA's unadjusted depreciable basis ($100,000) plus the expensed costs ($0), minus the amount previously recognized as ordinary income ($90,000). The remaining amount realized of $1,000 ($11,000 – $10,000) is IRC Sec. 1231 gain.

The depreciation allowance for the GAA in Year 3 would be $19,200 ($100,000 × .192) despite the fact that there are no assets remaining in the GAA. The depreciation reserve account at the end of Year 3 would be $71,200. The company would recover the rest of the $100,000 over the next three years.

(IRS Pub. 946, adapted)

The net effect of these transactions is that over six years the company will recognize $100,000 in ordinary income, take $100,000 of ordinary deductions and have a $1,000 IRC Sec. 1231 gain. This makes perfect sense since the company sold $100,000 of equipment for $101,000.

Disposition of All Property in a GAA

If a taxpayer disposes of all the property, or the last item of property, in a GAA, he/she could choose to end the GAA. In that case, gain or loss is calculated by comparing the adjusted depreciable basis of the GAA with the amount realized. If there is a gain, the amount subject to recapture as ordinary income is limited to the:

- Depreciation allowed or allowable for the GAA, including any expensed cost (such as IRC Sec. 179 deductions or the additional depreciation allowed or allowable for the GAA), minus
- Total gain previously recognized as ordinary income from the disposition of property in the GAA.

Example 7: Assume that Make & Sell chose to end the GAA in Year 3 when the remaining items are sold. The first difference would be that the depreciation allowance for Year 3 would be $9,600 ($100,000 × .192 × .50), since the modifying convention must be applied to the disposition.

Therefore at the close of the GAA, accumulated depreciation would be $61,600 (the $52,000 reserve at the end of Year 2 plus $9,600). The adjusted basis in the assets prior to the sale would be $38,400 ($100,000 – $61,600).The loss on the disposition would be $27,400 ($11,000 – $38,400). The company did not dispose of any other IRC Sec. 1231 assets during the year.

The net effect of the new transaction will be that over three years the company had a net ordinary gain of $62,600 ($90,000 ordinary gain in Year 2 and the $27,400 IRC Sec. 1231 loss) and $61,600 of ordinary deductions from cost recovery. This nets to the same $1,000 gain, but the character is now ordinary, rather than Sec. 1231, and the deductions come faster.

Voluntarily Removing Property from the GAA at Disposition

Property that is disposed of in a qualifying disposition can be removed from the GAA before calculating gains and losses at the taxpayer’s election. If the election is made, the basis for gain or loss is the adjusted basis of the asset, calculated using the same cost recovery methods used in the GAA.

A qualifying disposition is one that does not involve all the property, or the last item of property, remaining in a GAA and is a:

- Disposition that is a direct result of fire, storm, shipwreck, other casualty, or theft;
- Charitable contribution for which a deduction is allowed;
- Disposition that is a direct result of a cessation, termination, or disposition of a business, manufacturing, or other income-producing process, operation, facility, plant, or other unit (other than by transfer to a supplies, scrap, or similar account); or
- Nontaxable transaction, such as a like-kind exchange or an involuntary conversion, other than a nonrecognition transaction (described next) or a transaction that is nontaxable only because it is a disposition from a GAA.

Required Removal of Property from the GAA

Some transactions require the taxpayer to remove the property from the GAA before calculating gains and losses. Property must be removed from a GAA if it is:

- Disposed of in a nonrecognition transaction,
- Disposed of in an abusive transaction,
- Converted to personal use, and/or
- Subject to recapture of the investment credit, the credit for qualified electric vehicles, the IRC Sec. 179 deduction, or the deduction for clean-fuel vehicles and clean-fuel vehicle refueling property.

Nonrecognition Transactions

The following are non recognition transactions for this purpose:

- The distribution to one corporation of property in complete liquidation of another corporation.
- The transfer of property to a corporation solely in exchange for stock in that corporation if the transferor is in control of the corporation immediately after the exchange.
- The transfer of property by a corporation that is a party to a reorganization in exchange solely for stock and securities in another corporation that is also a party to the reorganization.
- The contribution of property to a partnership in exchange for an interest in the partnership.
- The distribution of property (including money) from a partnership to a partner.
- Any transaction between members of the same affiliated group during any year for which the group files a consolidated return.

Rules for Recipient (Transferee) in a Nonrecognition Transaction

The recipient of the property (the person to whom it is transferred) must include the transferor's adjusted basis in the property in a GAA. If all of the property or the last item of property in a GAA is transferred, the recipient's basis in the property is the:

- Adjusted depreciable basis of the GAA as of the beginning of the tax year in which the transaction takes place, minus
- Depreciation allowable in the year of the transfer.

For this purpose, the adjusted depreciable basis of a GAA is the unadjusted depreciable basis of the GAA minus any depreciation allowed or allowable for the GAA.

An Abusive Transaction

A disposition is an abusive transaction if a main purpose for the disposition is to get a tax benefit or a result that would not be available without the use of a GAA. Following are examples of abusive transactions:

- A transaction with a main purpose of shifting income or deductions among taxpayers in a way that would not be possible without choosing to use a GAA to take advantage of differing effective tax rates.
- Electing a GAA with a main purpose of disposing of property from the GAA in order to use an expiring net operating loss or credit.

The following transactions are considered abusive transactions unless there is strong evidence to the contrary:

- A transfer of GAA property to a related person.
- A transfer of GAA property under an agreement where the property continues to be used, or is available for use, by the taxpayer.

If property is removed from a GAA, the following adjustments are made to the GAA:

- The unadjusted depreciable basis of the GAA is reduced by the unadjusted depreciable basis of the property as of the first day of the tax year in which removal occurs.
- The depreciation reserve account is reduced by the depreciation allowed or allowable for the property (computed in the same way as computed for the GAA) as of the end of the tax year immediately preceding the removal.

Electing to Use a GAA

An election to include property in a GAA is made separately by each owner of the property. Therefore, an election to include property in a GAA must be made at the partnership or S corporation level.

How to Make the Election

Make the election by completing line 18 of Form 4562, Depreciation and Amortization (Including Information on Listed Property). For the year in which the property included in the GAA is placed in service, the election must be made:

- On a timely filed tax return (including extensions) or
- On an amended return filed within six months of the due date of a timely filed return (excluding extensions).

Revoking an Election

An election to use a GAA can only be revoked if:

- Property in the GAA generates foreign source income, both United States and foreign source income, or combined gross income of a foreign sales corporation (FSC), a domestic international sales corporation (DISC), or a possessions corporation and its related supplier; and
- That inclusion results in a substantial distortion of income.

Note, however, that if the taxpayer disposes of all the property, or the last item of property, in a GAA, she could choose to end the GAA as discussed here.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

16. Riverview Incorporated, a calendar-year taxpayer, purchased an apartment house on June 1 of last year for $1,200,000 of which $200,000 was allocated to the land. The corporation sold the property in Year 2 on September 27. Calculate the corporation's depreciation for the building for Year 2.

    a. $18,162.

    b. $19,700.

    c. $25,755.

    d. $36,360.

17. Houston Company acquired a 7-year asset in November 2005. This is the only asset the company placed in service during the year. The straight-line method, limited expensing, additional first year depreciation and the 150%-declining-balance method were **not** elected. The asset was sold in June of the current year. Which of the following statements is correct concerning cost recovery in the year of sale?

    a. The half-year convention applies.

    b. The mid-quarter convention applies.

    c. The mid-month convention applies.

    d. No depreciation is allowed in the year of sale because the property was sold.

18. Harvey Corp. acquired a 15-year asset for $100,000. It was placed in service in June. This is the only asset the company placed in service during that year. The straight-line method, limited expensing, and the 150%-declining-balance method were **not** elected. In addition, the company elected out of bonus depreciation. The property was sold in September of Year 4. What is the depreciation for the year of sale?

    a. $3,850.

    b. $4,813.

    c. $5,454.

    d. $7,700.

19. Buy and Keep Corporation set up a GAA for seven machines that were properly classified as half-year, 5-year property recovered under the 200%-declining-balance method. One of the machines cost $60,000, and the remaining six cost a total of $40,000. The company was not entitled to additional first-year depreciation and elected not to claim IRC Sec. 179 expensing. At the beginning of Year 2, the company sold one of the smaller pieces that originally cost $8,000 for $5,000. What is the company's depreciation deduction for Year 2?

    a. $29,440.

    b. $30,720.

    c. $32,000.

    d. $38,000.

20. Which of the following statements is accurate?

    a. All members of a partnership must elect to include partnership property in a GAA account.

    b. If Dave Co. sold an asset from a GAA account and arranged to lease it back, this is probably an abusive transaction that will require the removal of the asset from the GAA.

    c. If our taxpayer sold one of 10 items included in a GAA this year to an unrelated party in a taxable transaction, and the taxpayer did **not** claim the IRC Sec. 179 deduction and elected **not** to claim a special depreciation allowance, the property must be removed from the GAA.

    d. Jake Company's transfer of an asset contained in a GAA account from its mining division to its software division would be treated as a disposition.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

16. Riverview Incorporated, a calendar-year taxpayer, purchased an apartment house on June 1 of last year for $1,200,000 of which $200,000 was allocated to the land. The corporation sold the property in Year 2 on September 27. Calculate the corporation's depreciation for the building for Year 2. **(Page 48)**

    a. $18,162. [This answer is incorrect. This is what it would be if the building was nonresidential and sold in September. The table percentage for commercial building for 12 months is 2.564%. Since the mid-month convention applies, the company gets 8.5/12 of a full year.]

    b. $19,700. [This answer is incorrect. This is the deduction for the first year. Since the building was placed in service in June, the taxpayer was entitled to 6.5 months of cost recovery in Year 1.]

    c. $25,755. [This answer is correct. The table percentage of 3.636% must be adjusted to reflect the fact that the corporation only owned the property for nine months. Since the mid-month convention applies, the company gets 8.5/12 of a full year.]

    d. $36,360. [This is incorrect. If the corporation owned the building for the full year, the depreciation would equal $36,360.]

17. Houston Company acquired a 7-year asset in November 2005. This is the only asset the company placed in service during the year. The straight-line method, limited expensing, and the 150%-declining-balance method were **not** elected. The asset was sold in June of the current year. Which of the following statements is correct concerning cost recovery in the year of sale? **(Page 50)**

    a. The half-year convention applies. [This answer is incorrect. In a year of early disposition, the same modifying convention that was used at acquisition must be applied to the table percentage. This property was not half-year property in the year it was placed in service.]

    b. The mid-quarter convention applies. [This answer is correct. In a year of early disposition, the same modifying convention that was used at acquisition must be applied to the table percentage. This property was mid-quarter property in the year it was placed in service because it was acquired in the fourth quarter and was 100% of total acquisitions. Therefore, the mid-quarter convention applies in the year of sale.]

    c. The mid-month convention applies. [This answer is incorrect. In a year of disposition, the same modifying convention that was used at acquisition must be applied to the table percentage. This property was not mid-month property in the year it was placed in service.]

    d. No depreciation is allowed in the year of sale because the property was sold. [This answer is incorrect. In a year of disposition, the same modifying convention that was used at acquisition must be applied to the table percentage. It is only if the property was both acquired and disposed of in the same tax year that no depreciation is allowed.]

18. Harvey Corp. acquired a 15-year asset for $100,000. It was placed in service in June. This is the only asset the company placed in service during that year. The straight-line method, limited expensing, and the 150%-declining-balance method were **not** elected. In addition, the company elected out of bonus depreciation. The property was sold in September of Year 4. What is the depreciation for the year of sale? **(Page 51)**

    a. $3,850. [This answer is correct. This is half-year, 15-year property in Year 4, so the modifying convention in the year of disposition is one-half. The calculation is $100,000 × .0770 × 0.5. You should be using Table A-1 (Appendix A1).]

    b. $4,813. [This answer is incorrect. This is half-year, 15-year property in Year 4. The mid-quarter convention is never correct for this property. You should be using Table A-1 (Appendix A1).]

    c. $5,454. [This answer is incorrect. This is half-year, 15-year property in Year 4. The mid-month convention is never correct for this property. You should be using Table A-1 (Appendix A1).]

    d. $7,700. [This answer is incorrect. This is half-year, 15-year property in Year 4, but it was sold during Year 4 and you need to add a modifying convention. You should be using Table A-1.]

19. Buy and Keep Corporation set up a GAA for seven machines that were properly classified as half-year, 5-year property recovered under the 200%-declining-balance method. One of the machines cost $60,000, and the remaining six cost a total of $40,000. The company was not entitled to additional first-year depreciation and elected not to claim IRC Sec. 179 expensing. At the beginning of Year 2, the company sold one of the smaller pieces that originally cost $8,000 for $5,000. What is the company's depreciation deduction for Year 2? **(Page 54)**

    a. $29,440. [This answer is incorrect. The basis of the assets subject to cost recovery is not $92,000. When a taxpayer elects to use a GAA, the unadjusted basis of the assets in the account is not reduced by dispositions.]

    b. $30,720. [This answer in incorrect. This would have been the correct answer if the company had been entitled to a full deduction for the remaining $92,000 of assets and had taken a half year on the $8,000 of basis that was sold.]

    c. $32,000. [This answer is correct. The taxpayer is entitled to 32% of the full $100,000. When a taxpayer elects to use a GAA, the unadjusted basis of the assets in the account is not reduced by dispositions. Thus, the basis for cost recovery is still $100,000 despite the fact that an asset was sold.]

    d. $38,000. [This answer is incorrect. This would have been the correct answer if the property was 4th quarter mid-quarter property. When a taxpayer elects to use a GAA, the unadjusted basis of the assets in the account is not reduced by dispositions, therefore, the basis for cost recovery is still $100,000 despite the fact that an asset was sold.]

20. Which of the following statements is accurate? **(Page 57)**

    a. All members of a partnership must elect to include partnership property in a GAA account. [This answer is incorrect. An election to include property in a GAA is made separately by each owner of the property. Therefore, an election to include property in a GAA must be made at the partnership or S corporation level.]

    b. If Dave Co. sold an asset from a GAA account and arranged to lease it back, this is probably an abusive transaction that will require the removal of the asset from the GAA. [This answer is correct. A transfer of GAA property under an agreement where the property continues to be used, or is available for use, by the taxpayer will generally be considered an abusive transaction.]

    c. If our taxpayer sold one of 10 items included in a GAA this year to an unrelated party in a taxable transaction, and the taxpayer did **not** claim the IRC Sec. 179 deduction and elected **not** to claim a special depreciation allowance, the property must be removed from the GAA. [This answer is incorrect. Property must be removed from a GAA if it is disposed of in a non recognition transaction, disposed of in an abusive transaction, converted to personal use, or subject to recapture. None of these situations apply to our facts.]

    d. Jake Company's transfer of an asset contained in a GAA account from its mining division to its software division would be treated as a disposition. [This answer is incorrect. Property in a GAA is only considered disposed of if it is permanently withdrawn from use in an activity that gives rise to depreciation; transferred to a supplies, scrap, or similar account; or sold, exchanged, retired, physically abandoned, or destroyed. Here the property was moved from one depreciable activity to another one within the same taxpayer's operations.]

EXAMINATION FOR CPE CREDIT

Lesson 4

Determine the best answer for each question below. Then log onto our Online Grading Center at **OnlineGrading.Thomson.com** to record your answers.

15. Maryland Corp. purchased a 7-year asset in July for $200,000. More than 40% of the total additions for that year were placed in service during the fourth quarter. The straight-line method, and the 150%-declining-balance method were not elected. In addition, IRC Sec. 179 and bonus depreciation were not taken. Maryland Corp. sold the 7-year property in March of Year 3. What is the depreciation allowable in the year of sale? (Round to the nearest whole number.)

    a. $2,885.

    b. $4,555.

    c. $18,220.

    d. $36,440.

16. In July, Yazzo Corp. placed in service a 10-year asset that cost $27,000. This is the only asset the company placed in service during the year. The straight-line method, and the 150%-declining-balance method were not elected. In addition, IRC Sec. 179 and bonus depreciation were not taken. If the asset is disposed of in May of Year 4, what will the depreciation for the year of sale be?

    a. $1,116.

    b. $1,555.

    c. $1,944.

    d. $3,110.

17. Maryland Corp. purchased a 10-year asset in January for $200,000. This is the only asset the company placed in service during that year. The straight-line method, and the 150%-declining-balance method were not elected. The company did not elect IRC Sec. 179 expensing and elected out of bonus depreciation. Maryland Corp. sold the 10-year property in February of Year 5. What is the depreciation allowable in the year of sale? (Round to the nearest whole number.)

    a. $4,350.

    b. $6,850.

    c. $9,220.

    d. $18,440.

18. BigBuddy Corporation set up a GAA for several machines that were properly classified as half-year, 5-year property recovered under the 200%-declining-balance method. One of the machines cost $60,000 and the rest cost a total of $40,000. The company did not claim the IRC Sec. 179 deduction and elected out of the special depreciation allowance. Which of the following is a true statement concerning any dispositions of assets included in this GAA that are not removed from the GAA prior to calculating gain or loss?

    a. The disposed of property is treated as having an adjusted basis of zero.

    b. The amount realized will always be the amount of ordinary gain recognized on the transaction.

    c. A disposition will cause the modifying convention to be applied to the entire unadjusted basis of the GAA.

    d. A disposition will cause the modifying convention to be applied to that portion of the unadjusted basis of the GAA that relates to the amount disposed of.

19. When can an election to use a GAA be revoked?

    a. When income is greatly distorted because an item in the GAA generates foreign-source income.

    b. When an item in the GAA is disposed of because of loss in a fire.

    c. When an item in the GAA is converted to personal use.

    d. When an item in the GAA is contributed in exchange for interest in a partnership.

Lesson 5: Alternative Depreciation System and Alternative Minimum Tax

Introduction

In this lesson, you will learn how to identify when MACRS does not apply, how to adjust depreciation for the alternative minimum tax, and how to apply special MACRS rules for changes in the assets use.

Learning Objectives

Completion of this lesson will enable you to:

- Identify property excluded from MACRS.
- Compute depreciation for the Alternative Depreciation System (ADS) and Alternative Minimum Tax (AMT).

Alternative Depreciation System (ADS)

Under MACRS, a taxpayer who does not want to use a declining-balance method for property in a particular MACRS class may instead elect to depreciate the property in that class by using a straight-line rate over the recovery period represented by that MACRS class.

Alternatively, the taxpayer may elect the straight-line rate over the longer recovery periods of the alternative depreciation system (ADS).

When ADS is required, however, the longer ADS lives must be used.

Note: For the Alternative Minimum Tax, equipment placed in service after January 1, 1999, uses the recovery periods prescribed by the GDS. Prior to that the recovery periods prescribed by the ADS system were used.

Note if additional first year depreciation still applies to your client: A taxpayer is entitled to take bonus depreciation on qualified property when ADS is elected. Additional first year depreciation is not allowed when ADS is **required**.

ADS **must** be used for the following (IRC Sec. 168(g)):

- Listed property used 50% or more for nonqualifying business use
- Properties used predominantly outside the United States
- Tax-exempt–use property
- Tax-exempt, bond-financed property
- Imported property restricted by presidential executive order
- Certain pre-production costs of farming property excluded from the inventory-capitalization rule of IRC Sec. 263A

ADS is also used for (IRC Sec. 56(g)(4)(A)(i)):

- Property covered by an election made under IRC Sec. 168(g)(7) (this means the taxpayer elects to use ADS) and
- Property placed in service in taxable years beginning after 1989 when calculating depreciation for adjusted current earnings (ACE). ACE is one of the adjustments a corporate taxpayer must make in determining alternative minimum taxable income.

Note: Corporate earnings and profits (E&P) determine how much of corporate dividends will be taxed as ordinary income.

E&P is reduced only by ADS depreciation unless a corporation uses a depreciation method that does not refer to years, such as "units-of-production" or "machine hours." The additional first-year depreciation deduction is also not allowed. IRC Sec. 179 expensing amounts must be amortized over five years.

Where the alternative depreciation system (ADS) is required, property must be recovered over its designated class life. For instance, most office furniture and fixtures with a recovery period of seven years have a class life of 10 years, as do many other items in the 7-year recovery period.

Some of the more common class lives for ADS are as follows (IRC Sec. 168(g)(2)):

- 5 years—for automobiles, light-purpose trucks, computers, or peripheral equipment
- 12 years—for personal property with no class life
- 40 years—for nonresidential real property and residential rental property other than low- or moderate-income housing property financed by tax-exempt bonds

Note: A complete list of class lives can be found in Rev. Proc. 87-56, 1987-2 CB 674; Rev. Proc. 88-22, 1988-1 CB 785; Appendix B of IRS Pub. 946; and most tax services.

Under the ADS, the applicable modifying convention is determined using the same rules we covered earlier (IRC Sec. 168(g)(2)).

Reminder: A taxpayer may make an "irrevocable election" under IRC Sec. 168(g)(7) to have any **recovery class** of property for any taxable year, use the ADS rather than the general depreciation system (GDS).

If the election is made, **all property** in such class placed in service during such taxable year must use the ADS.

Important: In the case of nonresidential real property and residential rental property, the election to use the ADS is made on a property-by-property basis.

Property Excluded from MACRS

MACRS does **not** apply to the following property (IRC Sec. 168(f)):

- Tangible property used predominantly outside the United States during the year
- Intangibles

- Property that the taxpayer properly elects to depreciate under a depreciation method not expressed in terms of years (i.e., units-of-production method)
- Motion picture film and videotape
- Sound recordings
- Any public utility property, if the taxpayer does **not** use a normalization method of accounting

Note: The American Jobs Creation Act of 2004 allows the cost of certain film and television productions to be expensed. It also allows the inclusion of participations and residuals in the adjusted basis. These changes are beyond the scope of this course; however, they are substantial in nature and should be studied carefully by anyone working in the entertainment industry. This provision expired for productions that commenced after December 31, 2009.

Used Predominantly outside the United States

Tangible property used predominantly outside the United States during the tax year must be depreciated under ADS. Property is used predominantly outside the United States if it is located outside the United States (only the 50 states and the District of Columbia) for more than 50% of the taxpayer's tax year.

The period in which the property is physically located outside the United States is compared to the period in which the property is physically located within the United States during the tax year.

Twelve different types of property are exempted from the predominant-use test. These include satellites and spacecraft launched by a U.S. person from the United States and containers owned by a U.S. person used to transport property to and from the United States.

A change in the use of property occurs when a taxpayer begins or ceases to use MACRS property predominantly outside the United States. In 2004, the IRS issued final regulations that provide guidance in determining:

- When to convert from GDS to ADS in the case of property previously used predominantly within the United States to now being used predominantly outside the United States and
- When to convert from ADS to GDS in the case of property previously used predominantly outside the United States to now being used predominantly within the United States.

Method Not Expressed in Terms of Years

IRC Sec. 168(f)(1) excludes from MACRS tangible property that the taxpayer properly elects to depreciate under a method not expressed in terms of years.

The taxpayer must make the election in the first taxable year in which depreciation would be allowable. If this election is made, the property is no longer qualifying property for purposes of applying the additional first-year depreciation deduction.

Example 1: The following are depreciation methods that are not expressed in terms of years:

- Units-of-production method (i.e., tons of ore, barrels of oil)
- Machine hours
- Operating days
- Miles driven

Remember: If property being depreciated is **not** subject to MACRS, the salvage value that exceeds 10% of the cost must reduce the depreciable basis.

Example 2: Units-of-production. Cost of tangible asset is $500,000. Salvage value in excess of 10% of cost equals $10,000. Estimated total barrels of oil equals 4.9 million.

The depreciation allowed is $0.10 per barrel of oil produced.

$500,000 – $10,000 = $490,000 depreciable basis

$490,000 ÷ 4,900,000 total estimated barrels of oil = $0.10 per barrel

If 300,000 barrels of oil were produced during the year, the depreciation deduction would be $30,000 ($0.10 × 300,000).

Alternative Minimum Tax (AMT)

IRC Sec. 55(b)(2) provides that, for purposes of AMT imposed by IRC Sec. 55, the term **alternative minimum taxable income** means the regular taxable income of the taxpayer for the taxable year with certain adjustments. IRC Sec. 56(g)(4) provides that, for purposes of determining the amount of the alternative minimum taxable income for any taxable year, an adjustment to regular taxable income must be made for depreciation claimed on assets placed in service after 1986.

Generally, you must refigure depreciation for the AMT. No AMT adjustment is required for any qualifying property on which additional first-year depreciation is claimed. This includes both the bonus deduction and the MACRS deduction on the remaining basis. No adjustment is required for the deduction taken under IRC Sec. 179.

Note: For the remainder of this lesson we will ignore issues related to additional first-year depreciation.

For AMT purposes, depreciation deductions for **personalty** (personal property) are calculated using the 150%-declining-balance method, switching to straight-line in the taxable year that maximizes the depreciation allowance.

Personalty placed in service after 1986 and prior to January 1, 1999, uses the recovery periods prescribed by the ADS. Personalty placed in service after 1998 uses the recovery periods prescribed by the GDS (IRC Sec. 56(a)(1)).

Residential and nonresidential property placed in service prior to January 1, 1999, uses a 40-year life for AMT purposes. Residential and nonresidential property placed in service after 1998 uses the recovery periods prescribed by the GDS (27.5 years for residential property and 39 years for nonresidential property). That means there is no AMT adjustment for real property placed in service after 1998.

Since the 150%-declining-balance method, switching to the straight-line method is the default for 15-year and 20-year recovery property, no AMT adjustment is required for property in these recovery classes that is placed in service after 1998.

The straight-line method can be elected in lieu of the 150%-declining-balance method.

The half-year and mid-quarter conventions still apply to personal property. The mid-month convention still applies to real property (Rev. Proc. 87-57, 1987-2 CB 687).

In calculating the depreciation **adjustment** required for AMT for assets placed in service after 1986, the aggregate depreciation for regular tax is compared to the aggregate depreciation for the alternative minimum tax.

If the **total** depreciation for regular tax is greater (less) than the **total** depreciation for the AMT, the **adjustment** (or difference) will increase (or decrease) the regular taxable income.

Since the 200%-declining-balance method of depreciation is the default for 3-year, 5-year, 7-year and 10-year recovery property, and MACRS and the 150%-declining-balance method of depreciation are used for AMT purposes, the depreciation deduction for these assets in earlier years will be greater for regular tax purposes than for AMT purposes with the reverse being true in later years.

Example 3: John Jones puts a $3,000 asset into service in May of this year. It is a 3-year class asset with an ADS life of four years. IRC Sec. 179 expensing is not elected. The depreciation deduction for Year 1 is as follows:

Regular tax = $3,000 × (2 ÷ 3 years) × ½ year = $1,000
AMT = $3,000 × (1.5 ÷ 3 years) × ½ year = $750
AMT adjustment = $1,000 – $750 = $250

Regular taxable income must be increased by $250 for the AMT calculation.

Note: The adjustment mechanism that permits "netting" (i.e., **all** regular tax depreciation is compared to **all** AMT depreciation) means that, in years that the regular depreciation is **greater** than the AMT depreciation, there will be an upward adjustment for the difference, increasing the alternative minimum taxable income.

In years in which the aggregate regular tax depreciation is **less** than the aggregate AMT depreciation, a downward adjustment will occur for the difference in depreciation, decreasing the alternative minimum taxable income.

A depreciation **adjustment** for AMT can be avoided in one of two ways:

1. The taxpayer can elect to use the AMT depreciation for purposes of computing regular taxable income.
2. The taxpayer can elect to use the straight-line method of depreciation in computing **both** the regular taxable income and the AMT.

Note: For assets placed in service prior to January 1, 1999, the taxpayer would also have had to elect to use the ADS recovery periods for regular tax purposes to avoid an AMT adjustment (IRC Secs. 56(a)(1), 168(b) and (c)).

Reminder: The election to **avoid the AMT adjustment** is made on a class-by-class and year-by-year basis for **all** property **except** residential rental property and nonresidential real property.

Adjustments for AMT do not apply to the following types of property that are excluded from MACRS:

- Sound recordings described in IRC Sec. 48(r)(5) (IRC Secs. 56(a)(1)(B) and 168(f)(4))
- Films and videotapes that are generally depreciated under the income-forecast method (IRC Secs. 56(a)(1)(B) and 168(f)(3))
- Any property that is depreciated under the units-of-production method or any other method of depreciation not expressed in terms of years (IRC Secs. 56(a)(1)(B) and 168(f)(1)(B))
- Any property with respect to which the taxpayer makes an election to depreciate under the ADS (IRC Secs. 56(a)(1)(B) and 168(f)(1)(A))
- Certain public utility property (described in IRC Sec. 167(l)(3)(A)) if the taxpayer does not use a normalization method of accounting (IRC Secs. 56(a)(1)(B) and 168(f)(2))
- Certain property placed in service after December 31, 1986, that qualifies for transition relief and, therefore, is excepted from the application of MACRS (IRC Sec. 56(a)(1)(C))
- Property that is expensed (up to $500,000 for 2010) under IRC Sec. 179
- Qualifying property on which an additional first-year depreciation allowance is claimed

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

21. Personal property that has no class life is assigned a ______-year life for the ADS.

    a. 5.

    b. 10.

    c. 12.

    d. 40.

22. Carol Zellores purchased a machine for $15,000 in May of the current year. The manufacturer estimates the machine's useful life at 100,000 hours. During the first year, Carol ran the machine for 5,000 hours. The salvage value of the machine in excess of 10% of machine cost is $1,000. IRC Sec. 179 is **not** elected and bonus depreciation is not taken. If Carol elects the units-of-production method, what is the depreciation allowed in the first year?

    a. $0.

    b. $700.

    c. $750.

    d. $15,000.

23. For the alternative minimum tax (AMT) calculation, which of the following depreciation methods applies to 5-year property placed in service in 2010, assuming that the election to use an alternative method for GDS is **not** made?

    a. Straight-line method for the entire life.

    b. 150%-declining-balance method, switching to the straight-line method in the taxable year that maximizes the depreciation allowance.

    c. 200%-declining-balance method, switching to the straight-line method in the taxable year that maximizes the depreciation allowance.

24. Which of the following depreciation methods for regular tax require an AMT adjustment in 2009 for property placed in service in 2008 if the taxpayer elected **not** to claim bonus depreciation?

    a. Depreciation based on MACRS applicable to 3-year property.

    b. Depreciation on residential rental property based on a 27.5 life.

    c. Depreciation based on MACRS applicable to 15-year property.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

21. Personal property that has no class life is assigned a ______-year life for the ADS: **(Page 68)**

    a. 5. [This answer is incorrect. This is the class life assigned to computers and automobiles as stated in IRC Sec. 168(g)(2). It is also the recovery period for these assets.]

    b. 10. [This answer is incorrect. Most office furniture and fixtures with a recovery period of seven years have a class life of 10 years, as do many other items in the 7-year recovery period per the IRS regulations.]

    c. 12. [This answer is correct. In accordance with IRC Sec. 168(g)(2), personal property that has no class life is assigned a 12-year life for the ADS.]

    d. 40. [This answer is incorrect. This is the class life assigned to buildings per IRC Sec. 168(g)(2).]

22. Carol Zellores purchased a machine for $15,000 in May of the current year. The manufacturer estimates the machine's useful life at 100,000 hours. During the first year, Carol ran the machine for 5,000 hours. The salvage value of the machine in excess of 10% of machine cost is $1,000. IRC Sec. 179 is **not** elected and bonus depreciation is not taken. If Carol elects the units-of-production method, what is the depreciation allowed in the first year? **(Page 70)**

    a. $0. [This answer is incorrect. Depreciation is allowed in the year the depreciable asset is acquired.]

    b. $700. [This answer is correct. The depreciation allowed is 14 cents per hour run.

    $15,000 – $1,000 = $14,000 depreciable basis

    $14,000 ÷ 100,000 total estimated hours = $0.14 per hour

    There were 5,000 hours of use during the year, so the depreciation is $0.14 × 5,000 = $700. Bonus depreciation is not allowed (IRC Sec. 168(f)(1)).]

    c. $750. [This answer is incorrect. Salvage value must reduce the basis before depreciation is calculated.]

    d. $15,000. [This answer is incorrect. The entire cost cannot be written off in the year of acquisition without an IRC Sec. 179 election. If IRC Sec. 179 had been elected, the $15,000 would have been expensed (not depreciated). Taxpayers may elect to deduct rather than depreciate up to $250,000 of the cost for property placed in service in 2008 (IRC Sec. 168(b)(1)).]

23. For the alternative minimum tax (AMT) calculation, which of the following depreciation methods applies to 5-year property placed in service in 2010 assuming that the election to use an alternative method for GDS is **not** made? **(Page 71)**

    a. Straight-line method for the entire life. [This answer is incorrect. The straight-line method is permitted to be used only if elected by the taxpayer (IRC Sec. 168(g)(7)).]

    b. 150%-declining-balance method, switching to the straight-line method in the taxable year that maximizes the depreciation allowance. [This answer is correct. The 150%-declining-balance method, switching to the straight-line method in the taxable year that maximizes the depreciation allowance is used for the AMT calculation for 5-year property (IRC Sec. 56(a)(1)).]

    c. 200%-declining-balance method, switching to the straight-line method in the taxable year that maximizes the depreciation allowance. [This answer is incorrect. The 200%-declining-balance method of depreciation, switching to the straight-line method in the taxable year that maximizes the depreciation allowance is used for regular *tax* purposes (general depreciation system), **not** for AMT purposes (IRC Sec. 56(a)(1)).]

24. Which of the following depreciation methods for regular tax require an AMT adjustment in 2009 for property placed in service in 2008 if the taxpayer elected **not** to claim bonus depreciation? **(Page 72)**

    a. Depreciation based on MACRS applicable to 3-year property. [This answer is correct. MACRS depreciation is not allowed for purposes of AMT. An adjustment is required. AMT must be calculated using the 150%-declining-balance method over three years (IRC Sec. 56(a)(1)(B)).]

    b. Depreciation on residential rental property based on a 27.5 life. [This answer is incorrect. Residential rental property placed in service after 1998 will use 27.5 years for MACRS and AMT and the straight-line method. An adjustment is **not** required. Buildings that were placed in service prior to 1999 must be depreciated over 40 years for AMT using the straight-line method (IRC Sec. 56(a)(1)(B)).]

    c. Depreciation based on MACRS applicable to 15-year property. [This answer is incorrect. For both AMT and MACRS, the property is recovered by the 150%-declining-balance method over 15 years. An adjustment is **not** required for property placed in service after December 31, 1998. If the property had been placed in service prior to December 31, 1998, the recovery period would have been longer for AMT purposes (IRC Sec. 56(a)(1)(B)).]

EXAMINATION FOR CPE CREDIT

Lesson 5

Determine the best answer for each question below. Then log onto our Online Grading Center at **OnlineGrading.Thomson.com** to record your answers.

20. Denver Inc. purchased a $20,000, 5-year asset in August. This was the only asset the company placed in service during the year. The straight-line method was elected and no IRC Sec. 179 expensing or bonus depreciation was taken. What is the depreciation for the first year?

    a. $0.

    b. $1,000.

    c. $2,000.

    d. $2,500.

21. Which of the following methods of depreciation, if elected, excludes property from MACRS?

    a. Double-declining balance method.

    b. Miles driven.

    c. Straight-line method.

    d. Forecast method.

22. The units-of-production method is used to calculate depreciation on an asset acquired and placed in service in May of this year. IRC Sec. 179 is not elected. In addition, the entity elected out of bonus depreciation. What is the depreciation for this year?

Asset cost when acquired	$ 40,000
Salvage in excess of 10% of basis	$ 5,000
Total estimated units to be produced	100,000
Total units produced this year	40,000

    a. $10,000.

    b. $12,000.

    c. $14,000.

    d. $16,000.

23. Which of the following requires a depreciation adjustment for AMT?

    a. Property expensed under IRC Sec. 179.

    b. Real property placed in service after 1998.

    c. 15-year recovery property placed in service after 1998.

    d. Personalty placed in service after 1986.

24. Edgar, Inc. puts a $6,000 asset into service in May of this year. It is a 3-year class asset with an ADS life of four years. IRC Sec. 179 expensing is not elected. In addition, the company elects out of bonus depreciation. How much is the regular tax depreciation for the first year? (Hint: use rounding).

    a. $480.

    b. $1,500.

    c. $1,980.

    d. $2,000.

25. Using the facts in Question 24, what is the amount of depreciation for AMT purposes for the first year?

    a. $480.

    b. $1,500.

    c. $1,980.

    d. $2,000.

Lesson 6: Short Tax Years, IRC Section 179 and Bonus Depreciation

Introduction

In this lesson, you will learn the rules that cover the use of IRS optional tables, figure depreciation in a short tax year, understand depreciation in recovery years after a short tax year, identify limited expensing under IRC Sec. 179, and a variety of situations that require adjustments to the basis of property subject to cost recovery.

Learning Objectives

Completion of this lesson will enable you to:

- Identify MACRS deductions in a short tax year.
- Identify IRC Sec. 179 property and property qualifying for special (bonus) depreciation.

MACRS Deductions in a Short Tax Year

At the beginning of this lesson, we will discuss short tax years. We will then use the rest of this lesson to cover limited expensing under IRC Sec. 179 and additional adjusting basis before you use the table percentages.

Key Term: A **short tax year** is any tax year with less than 12 full months.

For a short tax year beginning on the first day of a month or ending on the last day of a month, the tax year consists of the number of months in the tax year. If the short tax year includes part of a month, you would generally include the full month in the number of months in the tax year.

If the short tax year does not start on the first day of a month or end on the last day of the year, the tax year is the actual number of days in the short year. The midpoint is determined by dividing the number of days by two. If that is not the first day or midpoint of a month, the date placed in service is the nearest **preceding** first day or midpoint.

The half-year, mid-quarter, and mid-month conventions establish the date property is treated as placed in service and the disposition date.

Figuring Depreciation in a Short Tax Year

To figure depreciation in a short tax year, do not use the MACRS percentage tables. Follow these steps:

- First, determine the depreciation for a full tax year, disregarding the modifying conventions.
- Next, determine the depreciation for the short tax year by multiplying the depreciation for a full tax year by a fraction that represents the months in the short tax year adjusted by the applicable modifying convention:
    - The numerator of the fraction is the number of months (including parts of a month) that the property is treated as in service during the tax year.

- The numerator is adjusted by the mid-month (real estate) or mid-quarter/mid-year (equipment) conventions.
- The denominator is 12.

Mid-month Convention: Applies to real property. The numerator of the fraction is the number of months (including parts of a month) that the property is treated as in service during the tax year. Treat property as placed in service on the midpoint of the month placed in service. The denominator is 12. This is the same as a full 12-month year.

Example 1: A short tax year that begins on June 20 and ends on December 31 consists of seven months. A building placed in service in June would be entitled to 6.5/12 of one year of cost recovery in the first year. Another one placed in service in October would get 2.5/12 of the full year.

Mid-quarter Convention: As with a full 12-month year, for equipment, test for mid-quarter first. If the mid-quarter convention does not apply, the half-year convention (discussed below) will. The amount of property, not real estate, placed in service in the last three months of a tax year determines whether or not the mid-quarter convention applies. The length of the tax year does **not** matter.

A taxpayer must test to see if more than 40% of the total property placed in service during the tax year was placed in service during the last **three** months. If yes, the mid-quarter convention applies.

If the mid-quarter convention applies, the short year must be divided into four quarters to determine the midpoint of each quarter to calculate the number of months of recovery to allow for each quarter's additions.

If the result is a midpoint of a quarter that is on a day other than the first or a midpoint of a month, property is treated as placed in service on the nearest preceding first or midpoint of that month.

Example 2: Tara Corp., a calendar-year taxpayer, was incorporated and began business on March 15 of this year. It has a short tax year of 9½ months. The company does not want to elect Sec. 179 expensing and is not entitled to additional first-year depreciation.

It placed in service, on October 16, 5-year property with a basis of $10,000. On December 3, it placed in service 7-year property with a basis of $100,000. These are the only properties placed in service during the short tax year. The depreciation method for these properties is the 200%-declining-balance method.

The corporation must use the mid-quarter convention because more than 40% of applicable additions were placed in service in the last three months of the tax year.

(IRS Pub. 946, adapted)

Example 3: To apply the mid-quarter convention, the company must divide its short tax year into four quarters and determine the midpoint of each quarter.

- First, it determines that its short tax year beginning March 15 and ending December 31 consists of 292 days.
- Next, it divides 292 days by 4 to determine the length of each quarter (73 days).
- Finally, it divides 73 days by 2 to determine the midpoint of each quarter (the 37th day).

Remember: If the result is a midpoint of a quarter that is on a day other than the first or a midpoint of a month, property is treated as placed in service on the nearest **preceding** first or midpoint of that month.

Example 4: The table shows the quarters of Tara Corporation's short tax year, the midpoint of each quarter, and the date in each quarter that Tara must treat its property as placed in service.

Quarter	Midpoint	Deemed Placed in Service Date	Reason for Placed in Service Date
March 15–May 26	April 20	April 15	April 15 is nearer than April 1, and you look to preceding first day and midpoint.
May 27–Aug. 7	July 2	July 1	July 1 because you look at preceding periods and July 1 is closer than June 15.
Aug. 8–Oct. 19	Sept. 13	Sept. 1	Sept. 15 is closer, but is not before Sept. 13. Look to the preceding first day and midpoint.
Oct. 20–Dec. 31	Nov. 25	November 15	Nov. 15 is nearer than Nov. 1 and you look to preceding first day and midpoint.

(IRS Pub. 946, adapted)

Example 5: The last quarter of the short tax year begins on October 20, 73 days from the end of the tax year. The 37th day of the last quarter is November 25. Because the midpoint of the quarter is not the first or the midpoint of November, Tara Corp. must treat property placed in service between October 20 and December 31 as placed in service in the middle of November.

The 5-year property placed in service on October 16 (between August 8 and October 19) is treated as placed in service at the beginning of September, so it will get four months of cost recovery in the first year. The 7-year property placed in service on December 3 (between October 20 and December 31) is treated as placed in service at the middle of November, so it will get 1½ months of cost recovery in the first year.

(IRS Pub. 946, adapted)

Calculation for the 5-year Property Placed in Service in October

The corporation first multiplies the basis ($10,000) by 40% (1/5 × 2) to get the depreciation for a full tax year ($4,000). The corporation then multiplies $4,000 by 4/12 (September through December) to get its short-tax-year depreciation of $1,333.

Calculation for 7-year Property Placed in Service in December

The corporation first multiplies the basis ($100,000) by 28.57% (1/7 × 2) to get the depreciation for a full tax year ($28,570). The corporation then multiplies $28,570 by 1.5/12 (one-half of November and all of December) to get its short-tax-year depreciation of $3,571.

Half-year Convention: If there are no (or less than 40%) acquisitions in the last three months, the half-year convention will apply. The midpoint of the year is determined by dividing the number of months in the year by two. If the short tax year includes part of a month, include the full month in the calculation. Determine the midpoint of the tax year by dividing the number of months in the tax year by two.

> **Example 6:** A short tax year that begins on June 20 and ends on December 31 consists of seven months. Treat the tax year as beginning on June 1 instead of June 20. The midpoint of the tax year is the middle of September (3½ months from the beginning of the tax year).
>
> So you would adjust the full year's percentage by 3.5/12.

> **Example 7:** Tara Corp., with a short tax year beginning March 15 and ending December 31, has a tax year of 9½ months (treated as 10 full months).
>
> Tara placed in service, on March 16, 5-year property with a basis of $100,000. Limited expensing and additional first-year depreciation are **not** elected. This is the only property placed in service during the short tax year. The depreciation method for this property is the 200%-declining-balance method. The depreciation rate is 40% (1/5 × 2). The half-year convention applies since there were no additions in the last three months. The law allows Tara five months of depreciation for the short tax year of 10 months.
>
> Tara first multiplies the basis ($100,000) by 40% to get the depreciation for a full tax year of $40,000. The corporation then multiplies $40,000 by 5/12 to get the short tax year depreciation of $16,667.
>
> (IRS Pub. 946, adapted)

Not on First or Last Day of Month: For a short tax year that neither begins on the first day of the month nor ends on the last day of a month, the tax year consists of the number of days in the tax year. Determine the midpoint of the tax year by dividing the number of days in the tax year by two. For the half-year convention, if the result is not the first day or the midpoint of a month, treat the property as placed in service on the nearest preceding first day or midpoint of a month. You still look at additions made in the last three months to determine the modifying convention for equipment.

Depreciation in Recovery Years after Short Tax Year

Use either the simplified method **or** the allocation method.

The method chosen must be used consistently until the year of change to the straight-line method.

Simplified Method: Depreciation for subsequent tax years in the recovery period is calculated by multiplying the unrecovered basis of property at the beginning of the tax year by the applicable depreciation rate.

In our earlier example for the 5-year property with the mid-quarter convention in the short tax year, Tara Corp. claimed depreciation of $1,333 using a depreciation rate of 40% and 4/12 as the half-year convention for a 5-year asset with a cost basis of $10,000.

The unrecovered basis on January 1 of the second tax year is $8,667 ($10,000 – $1,333). Tara's depreciation for the next tax year will be 40% (1/5 × 2) of $8,667, or $3,467.

Allocation Method: Depreciation for each subsequent tax year is calculated by allocating to the tax year the depreciation attributable to the recovery year, or part of a recovery year, that falls within the tax year. This method requires the taxpayer to decline the basis of the property since the table is not being used.

For each recovery year included, multiply the depreciation attributable to each recovery period by a fraction.

- The numerator is the number of months (including parts of a month) that are in both the tax year and the recovery period.
- The denominator is 12.

The allowable depreciation for the tax year is the sum of the depreciation figured for each recovery year.

Note: In many cases, the two methods generate very similar results. Differences will occur if there is a disposition or short tax year. (Rev. Proc. 89-15, 1989-1 CB 816)

IRC Sec. 179 Property

IRC Sec. 179 provides an election to deduct all or part of the cost of certain qualifying property in the year it is placed in service. The cost can be currently deducted instead of recovered through depreciation deductions over the recovery period.

There are limits on the types of property and the amount that can be deducted in a tax year.

If property is used for both business and nonbusiness purposes, the IRC Sec. 179 deduction is available only if the property is used more than 50% in a trade or business in the tax year it is placed in service (Reg. Sec. 1.179-1(d)). (This will be discussed later in this lesson.)

Note: The IRC Sec. 179 amount does not need to be adjusted for a short tax year. This amount is not an add-back for the alternative minimum tax.

Two dollar limits apply to the IRC Sec. 179 deduction:

1. There is a maximum dollar amount that can be expensed. This dollar amount is reduced for taxpayers who place too much qualifying property in service above a threshold amount.

2. The taxpayer cannot use the IRC Sec. 179 deduction to create a loss.

Limits for 2008–2011

The 2008 Economic Stimulus Act had boosted IRC Sec. 179 expensing for the year 2008, and the American Recovery and Reinvestment Act of 2009 has extended that increase for 2009. The Hiring Incentives to Restore Employment Act of 2010 (the HIRE Act) has extended it once again for tax year 2010. For tax years 2008, 2009 and 2010 the expensing limit is increased to $250,000, and the overall investment limit is increased to $800,000 for each taxable entity; corporation, S corporation, partnership and individual (partner, S corporation shareholder.) The $250,000 and $800,000 amounts are not indexed for inflation (IRC Sec. 179(b)(7)).

For tax years beginning in 2010 and 2011, the Small Business Jobs Act of 2010, increases the maximum expensing amount to $500,000 and the investment ceiling to $2 million.

Note: IRC Sec. 179 is **not** available for estates or trusts. It cannot be used with real estate.

If the qualifying property placed in service exceeds the investment ceiling, the annual ceiling is reduced dollar-for-dollar for a qualifying investment exceeding the ceiling. Any dollar amount phased out is **not** carried forward to be used in future years.

In July 2005, the IRS issued final regulations (Reg. Sec. 1.179-5(c)) on revoking the IRC Sec. 179 election. The Small Business and Work Opportunity Tax Act extended a taxpayer's ability to revoke an IRC Sec. 179 expense election, and any specification contained in the election, to any tax year beginning before January 1, 2011. The Small Business Jobs Act of 2010 extended the ability to revoke an IRC Sec. 179 election without IRS consent to tax years beginning before 2012.

A taxpayer who wishes to revoke an IRC Sec. 179 election after the original return has been filed can change:

- The entire election,
- The election with respect to a specific item of IRC Sec. 179 property, or
- A selected dollar amount with respect to a specific item of IRC Sec. 179 property.

The regulations provide detailed examples of the different types of revocations that are available.

To change its IRC Sec. 179 election for any taxable year beginning after 2002 and before 2012, the taxpayer simply files an amended federal tax return. The amended return must restate depreciation on the property for which the election was revoked and adjust taxable income. Unless the new rule is extended again, for years after 2011, the taxpayer cannot revoke an election without the consent of the Commissioner.

Once an IRC Sec. 179 election has been revoked, it cannot be reversed.

Limitations: The following are limits on qualifying property:

- Qualifying property must be acquired for use in a trade or business.
- Property held only for the production of income does not qualify.
- Property must be acquired by purchase, but can be used property.
- Property acquired from a related person or group may not qualify, even if it was acquired by purchase.

If an asset is acquired with cash and a trade-in, the cost of qualifying property must be reduced by the basis of the trade-in.

Example 8: Silver Leaf, a retail bakery, traded two ovens (having a total adjusted basis of $680) for a new oven that cost $1,320. Silver Leaf placed the new items in service this year. Silver Leaf was given an $800 trade-in for the old ovens and paid $520 cash for the new oven. Silver Leaf's basis in the new property includes both the adjusted basis of the property traded and the cash paid. Only the portion of the new property's basis paid by cash qualifies for the IRC Sec. 179 deduction.

(IRS Pub. 946, adapted)

Property qualifying for the IRC Sec. 179 deduction is depreciable property used in a trade or business. As a result, the IRC Sec. 179 deduction is not available for property used in a residential rental unit. Qualifying property includes the following:

- Tangible personal property.
- Off-the-shelf computer software if placed into service in a year beginning after 2002 and before 2012 (described in IRC Sec. 197(e)(3)(A)(i), to which IRC Sec. 167 applies).
- Other tangible property (except buildings and their structural components) used as:
  - An integral part of manufacturing, production or extraction, or of furnishing transportation, communications, electricity, gas, water or sewage disposal services;
  - A research facility used in connection with any of the activities listed above; and
  - A facility used in connection with any of the activities listed above for the bulk storage of fungible commodities.
- Single-purpose agricultural (livestock) or horticultural structures.
- Storage facilities (except buildings and their structural components) used in connection with distributing petroleum or any primary product of petroleum.

Generally, leased property is not qualifying property for individual taxpayers. Leased property is qualifying property for all taxpayers if it is:

- Property leased to others that was manufactured by the taxpayer or
- Property leased to others if **both** of the following apply:
  - The term of the lease is less than half of the property's class life.

- For the first 12 months after the property is transferred to the lessee, the total of the business deductions that are allowed on the property (except rent and reimbursed amounts) is more than 15% of the rental income from the property.

Note: Due to the enactment of the Small Business Jobs Act of 2010, qualified real property is eligible for IRC Sec. 179 expensing for tax years beginning in 2010 and 2011. Assuming all other requirements are met, certain qualified leasehold improvement property, qualified restaurant property and qualified retail improvement property are eligible for IRC Sec. 179 expensing. The IRC Sec. 179 election for these types of property is limited to $250,000 per year. Any IRC Sec. 179 deduction for qualified real property that is unused due to the taxable income limit cannot be carried to a year beginning in 2011. Any carryforward remaining at the end of the tax year beginning in 2011 is treated as placed in service in that 2011 tax year (IRC Sec. 179(f)).

Net Income Limitation

The aggregate amount expensed under IRC Sec. 179 for any taxable year may **not** exceed the taxpaying entity's taxable income for that year derived from the active conduct by the taxpayer of any trade or business during the year (IRC Sec. 179(b)(3)).

Note: Trade or business income includes net IRC Sec. 1231 gain or loss, interest on working capital used in the business and any income earned as an employee.

Note: Taxable income for purposes of determining the maximum deduction under IRC Sec. 179 is determined without regard to the amount to be expensed under IRC Sec. 179 or other cost recoveries.

The taxable income of partnerships and S corporations is computed by aggregating the net income (or loss) from all of the trades or businesses actively conducted by the partnership or S corporation during the taxable year (IRC Sec. 179(b)(3) and Reg. Sec. 1.179-2(c)(4)).

Partnership net income is defined as aggregating all of the items of income (or loss); however, do **not** include any credits or tax-exempt income. Do not reduce the income by the guaranteed payments to the partners (IRC Sec. 179(b)(3) and Reg. Sec. 1.179-2(c)(4)).

S corporation net income also aggregates all items of income (or loss); however, do **not** include any credits or tax-exempt income. Do not reduce the net income by any wages paid to S corporation shareholder employees.

An individual's taxable income is calculated by aggregating the net income (or loss) from all of the trades or businesses actively conducted by the individual during the taxable year. This includes wages, salary, tips and other compensation derived by the taxpayer (IRC Sec. 179(b)(3); Reg. Secs. 1.179-2(c)(4) and (5)(iv)).

Unreimbursed employee business expenses incurred by the taxpayer as an employee are **not** included in the calculation of taxable income (Reg. Sec. 1.179-2(c)(5)(iv)).

Note: Married individuals filing separate returns are treated as one taxpayer for purposes of determining the amount that may be expensed and the total amount of investment in qualifying property. The dollar limit does not need to be allocated equally if both spouses agree. (IRC Sec. 179(b)(4)).

If the taxpayer has a taxable year of less than 12 months, the full amount for the year can still be expensed. Proration is **not** required (Reg. Sec. 1.179-1(c)(1)).

To the extent that the deduction is not allowed because of the annual limitation on taxable income, the **unused portion** is carried forward for an unlimited number of years. The annual deduction cannot exceed the ceiling for that tax year (IRC Sec. 179(b)(3)(B) and Reg. Sec. 1.179-3).

Reminder: You must reduce the basis of the asset for depreciation by the total amount of limited expensing claimed, even if some must be carried forward.

Limits on SUVs

The American Jobs Creation Act of 2004 capped first-year expensing for sport utility vehicles (SUVs) at $25,000. The limit is effective for vehicles placed in service after October 22, 2004.

The limits on vehicles discussed in the next lesson do not apply to vehicles with a loaded gross vehicle weight of more than 6,000 pounds. This exception was designed to allow heavy vehicles used in farming, construction and other businesses to take full benefit of cost recovery deductions. Many savvy tax advisors encouraged clients to purchase high-end SUVs in order to avoid the limits on passenger vehicles. Congress applied the $25,000 cap to address this issue.

The cap applies to SUVs that weigh 14,000 pounds or less and that are not subject to the limits on vehicles weighing 6,000 pounds or less. The cap on expensing does not affect the regular MACRS depreciation. So while it does limit the benefits of SUV ownership, they are still more attractive from a deduction perspective than passenger automobiles, and light vans and trucks.

Exceptions to the Cap on IRC Sec. 179 Expensing

The $25,000 cap on SUV expensing does not apply if the vehicle:

- Is designed to carry 10 or more individuals behind the driver's seat,
- Is equipped with an open cargo area or covered box at least six feet long and not readily accessible from the passenger compartment, or
- Has an enclosed driver compartment with no seating behind the driver.

Caution: Not all heavy pickup trucks have a cargo area of at least six feet in interior length. Anything less subjects the trucks to the $25,000 cap.

Example 9: Mary purchased a Hummer for $110,000 that she placed in service in May 2010 for exclusive use in her business. She elects IRC Sec. 179 expensing and double-declining-balance method for cost recovery. However, as you will learn later, since the Hummer is used property, she will not be able to use additional first-year depreciation. For 2010, she will be able to deduct $25,000 under IRC Sec. 179 and recover her remaining basis using the 5-year, mid-year table. Her MACRS depreciation is $17,000 (($110,000 – $25,000) × .20). Her total first-year deduction is $42,000 ($25,000 + $17,000).

Special (Bonus) Depreciation Allowance

The 2008 Economic Stimulus Act included a provision allowing an additional deduction of 50% of the property's depreciable basis (after any IRC Sec. 179 deduction and before figuring regular depreciation deductions). This provision was extended through December 31, 2008, by the Economic Recovery and Reinvestment Act of 2009.

The Small Business Jobs Act of 2010 extended bonus 50% first year depreciation to apply to property placed in service in 2010 (in 2011 for certain long production period property.)

The same general rules applied as those in effect under the Job Creation and Worker Assistance Act of 2002. Qualified property must meet all of these tests:

- It must be acquired by purchase after December 31, 2007, and before January 1, 2010. If a binding contract to acquire the property existed before January 1, 2008, the property does not qualify.
- Qualified property must be placed in service after December 31, 2007, and before January 1, 2010 (before January 1, 2011, for certain transportation property and certain property with a long production period). The original use of the property must begin with the taxpayer after December 31, 2007. Used property does not qualify for bonus depreciation; however, new property that is converted from personal to business use may qualify as original use property for this purpose.

Excluded property

Property that does not qualify for special depreciation allowance includes the following:

- Property placed in service and disposed of in the same tax year
- Property converted from business use to personal use in the same tax year it is acquired (Property converted from personal use to business use in the same or later tax year may not qualify.)
- Property required to be depreciated under the alternative depreciation system (ADS)
- Qualified restaurant property placed in service after December 31, 2008 (IRC Sec. 168(e)(7))
- Qualified retail improvement property placed in service after December 31, 2008 (IRC Sec. 168(e)(8))
- Property included in a class of property for which the taxpayer elected not to claim the special depreciation allowance
- Property for which unused alternative minimum tax and/or research credits are claimed in lieu of the deduction

When a taxpayer takes an IRC Sec. 179 deduction, the basis of property subject to MACRS must be reduced by the amount of the IRC Sec. 179 deduction before taking bonus depreciation or using the tables. We will indicate in the remaining study and test questions whether bonus depreciation will be included.

Business Vehicles. The limit on the amount of depreciation deductions for certain passenger automobiles (the IRC Sec. 280F limit) is increased in the first year by $8,000 for automobiles that qualify for the additional first-year depreciation deduction (if the taxpayer does not elect out.) This has been extended through December 31, 2010, by the Small Business Jobs Act of 2010. The $8,000 is not indexed for inflation.

Claiming credits instead of bonus depreciation

The Housing Assistance Act of 2008 allows corporations to claim some unused alternative minimum tax and/or research credits instead of taking the additional first-year deprecation deduction. This provision was extended through December 31, 2009, by the American Recovery and Reinvestment Act of 2009.

This is a refundable credit that is limited to the lesser of:

- 20% of the additional first-year depreciation that could have been claimed,
- 6% of the unused applicable credit carryforwards from pre-2006 tax years, or
- $30 million.

Bonus depreciation and the alternative minimum tax (AMT)

Unless the basis differs for the regular tax and AMT, no adjustment is required for AMT purposes for either bonus depreciation or the regular MACRS deduction on the remaining basis. If the taxpayer elects out of additional first-year depreciation, an AMT adjustment may be required.

Electing out of bonus depreciation

The election out of bonus depreciation is made on a class-by-class basis using a statement attached to the applicable tax return. The statement should indicate that the election is being made and to which classes of property the election applies.

Generally, the election should be made on a timely filed tax return (including extensions) for the year in which the property is placed in service. If the return was filed without the election, the taxpayer can file an amended return to elect out within six months of the original due date (not including extensions) of the return. An election statement must be attached to the amended return.

Once an election is made, it cannot be revoked without IRS consent.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

25. Davis Co. has a short tax year that began on April 1 and ended on December 31 of the current year. The company placed a residential building that cost $100,000 (land cost not included) in service in June. What is the maximum depreciation allowable in the first year?

    a. $1,389.

    b. $1,970.

    c. $3,636.

26. Davis Co. has a short tax year that began on July 5 and ended on December 3. The company placed a 7-year property that cost $100,000 in service in September. IRC Sec. 179 expensing was not elected. In addition, the company elected out of bonus depreciation. What is the maximum depreciation allowable in the first year?

    a. $3,571.

    b. $7,143.

    c. $10,000.

27. Beth purchased $150,000 of IRC Sec. 179 (5-year) property in August 2009. This was the only property she placed in service that year. Her taxable income from her business was over $500,000 for the year. What is her maximum first-year deduction relating to this property if she elects IRC Sec. 179 expensing?

    a. $30,000.

    b. $125,000.

    c. $150,000.

28. Beth purchased $520,000 of IRC Sec. 179 property in August 2010. This was the only property she placed in service that year. What is her maximum IRC Sec. 179 deduction for the year?

    a. $125,000.

    b. $250,000.

    c. $500,000.

29. Which of the following is an accurate statement?

    a. If the taxpayer elects to take an IRC Sec. 179 deduction, basis in the property must be reduced by that amount before applying the tables.

    b. If the taxpayer elects to take an IRC Sec. 179 deduction, basis in the property must be reduced by the table amount before applying the IRC Sec. 179 rules.

    c. If a taxpayer is unable to expense the full amount under IRC Sec. 179 because more than the phase-out amount was placed in service during the year, the full amount of the original IRC Sec. 179 amount reduces basis before the tables are applied.

    d. If the taxpayer is subject to both a phase-out reduction and an income limitation when calculating the IRC Sec. 179 deduction, basis does not have to be reduced by the amount that is carried over to the next tax year.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

25. Davis Co. has a short tax year that began on April 1 and ended on December 31 of the current year. The company placed a residential building that cost $100,000 (land cost not included) in service in June. What is the maximum depreciation allowable in the first year? **(Page 79)**

    a. $1,389. [This answer is incorrect. This would be the correct answer if the building was nonresidential.]

    b. $1,970. [This answer is correct. Determine the depreciation for a full tax-year, $100,000/27.5 = $3,636. Then apply the mid-month convention based on the number of months the building was in service, $3,636/12 = $303 x 6.5 = $1,970.]

    c. $3,636. [This answer is incorrect. This is the amount for a full year. You would never get a full year in the year placed in service, even if it was not a short year.]

26. Davis Co. has a short tax year that began on July 5 and ended on December 31. The company placed a 7-year property that cost $100,000 in service in September. IRC Sec. 179 expensing was not elected. In addition, the company elected out of bonus depreciation. What is the maximum depreciation allowable in the first year? **(Page 82)**

    a. $3,571. [This answer is incorrect. This would be the right answer if the taxpayer wanted to depreciate on a straight-line basis. There were no additions in the last three months, so the mid-year convention applies. Since there are six months in the short tax year, the taxpayer gets 3/12 of a full 12 months of depreciation computed on a double-declining basis. ($100,000 ÷ 7 × 2) × 3/12.]

    b. $7,143. [This answer is correct. You cannot use the tables because this is a short tax year. There were no additions in the last three months, so the half-year convention applies. Since there are six months in the short tax year, the taxpayer gets 3/12 of a full 12 months of depreciation computed on a double-declining basis. ($100,000 ÷ 7 × 2) × 3/12.]

    c. $10,000. [This answer is incorrect. This would be the right answer if the property had a 5-year recovery period.]

27. Beth purchased $150,000 of IRC Sec. 179 (5-year) property in August 2009. This was the only property she placed in service that year. Her taxable income from her business was over $500,000 for the year. What is her maximum first-year deduction relating to this property if she elects IRC Sec. 179 expensing? **(Page 84)**

    a. $30,000. [This answer is incorrect. This answer choice does not take the IRC Sec. 179 expensing into consideration. This is the depreciation using double-declining method for MACRS.]

b. $125,000. [This answer is incorrect. The 2009 IRC Sec. 179 deduction allowable is greater than $125,000 based on the IRC Sec. 179 expensing rules.]

c. $150,000. [This answer is correct. Beth's maximum first-year deduction allowed related to the property is $150,000 if she elects IRC Sec. 179 expensing based on IRS regulations.]

28. Beth purchased $520,000 of IRC Sec. 179 property in August 2010. This was the only property she placed in service that year. What is her maximum IRC Sec. 179 deduction for the year? **(Page 84)**

a. $125,000. [This answer is incorrect. Per the Small Business Jobs Act of 2010, the maximum IRC Sec. 179 deduction allowed for 2010 is greater than $125,000.]

b. $250,000. [This answer is incorrect. This is the maximum allowable IRC Sec. 179 expense for 2009.]

c. $500,000. [This answer is correct. The maximum allowable IRC Sec. 179 expense for 2010 is $500,000 with a threshold for phase-out of $2,000,000.]

29. Which of the following is an accurate statement? **(Page 87)**

a. If the taxpayer elects to take an IRC Sec. 179 deduction, basis in the property must be reduced by that amount before applying the tables. [This answer is correct. Basis in property must be reduced by the IRC Sec. 179 amount before applying the tables according to IRS regulations.]

b. If the taxpayer elects to take an IRC Sec. 179 deduction, basis in the property must be reduced by the table amount before applying the IRC Sec. 179 rules. [This answer is incorrect. Per the Internal Revenue Code, basis is reduced first by IRC Sec. 179 amount, not the table amount.]

c. If a taxpayer is unable to expense the full amount under IRC Sec 179 because more than the phase-out amount was placed in service during the year, the full amount of the original IRC Sec. 179 amount reduces basis before the tables are applied. [This answer is incorrect. Only the amount allowed after the phase-out has to reduce basis as stated by the Internal Revenue Code.]

d. If the taxpayer is subject to both a phase-out reduction and an income limitation when calculating the IRC Sec. 179 deduction, basis does not have to be reduced by the amount that is carried over to the next tax year. [This answer is incorrect. If the amount allowed after the phase-out is larger than the net income limitation, and the taxpayer still elects the maximum expensing, the excess reduces basis before the tables are applied (IRC 179(b)(3)(B)).]

EXAMINATION FOR CPE CREDIT

Lesson 6

Determine the best answer for each question below. Then log onto our Online Grading Center at **OnlineGrading.Thomson.com** to record your answers.

26. Davis Co. has a short tax year that begins on September 1 and ends on December 31. The company placed a 5-year property that cost $300,000 in service in September of this short year. Bonus depreciation and limited expensing are not taken. Alternative depreciation methods were not elected. What is the depreciation allowable for the short tax year? (Round to the nearest whole number.)

    a. $20,000.

    b. $21,000.

    c. $22,000.

    d. $30,000.

27. LLB, Inc., a calendar-year taxpayer, began business on April 15 of this year. It has a short tax year of 8½ months. LLB does not elect Section 179 expensing and is not entitled to additional first-year depreciation. During the short tax year, LLB placed property into service on October 30, November 15 and December 5. Which modifying convention applies?

    a. Half-year convention.

    b. Mid-month convention.

    c. Mid-quarter convention.

    d. Do not select this answer choice.

28. Janis acquired and placed in service $542,000 of qualifying IRC Sec. 179 property (not an SUV) in 2009. What is the IRC Sec. 179 investment ceiling for the year?

    a. $125,000.

    b. $250,000.

    c. $500,000.

    d. $800,000.

29. Jim Franklin acquired $16,000 of qualifying IRC Sec. 179 property (not an SUV) in 2010. The taxable income derived from the conduct of all of his businesses is $7,000. What is the amount of IRC Sec. 179 property that must be **carried forward** to the next tax year if Jim elects to expense the maximum amount?

    a. $0.

    b. $7,000.

    c. $9,000.

    d. $16,000.

Lesson 7: Adjustments to Basis, Luxury (Passenger) Automobiles, Light Vans and Trucks, Listed Property and Changes in Use

Introduction

In this lesson, you will learn about a variety of topics that reduce the basis of property subject to cost recovery: adjustment for the IRC Sec. 179 deduction and converting property from personal to business use, a prorated basis if property is used both for business and personal uses, a limitation on the total amount of the deduction allowed in a tax year. In this lesson, you will also learn about depreciation limits on passenger automobiles and light vans and trucks. You will also cover limits on equipment that is not used 100% for business (listed property). Finally, you will learn to use the alternative depreciation system (ADS), and the changes in MACRS related to changes in use.

Learning Objectives

Completion of this lesson will enable you to:

- Identify the limitations on cost recovery, passenger automobiles and light vans and trucks.
- Recognize listed property.

Adjustments to Basis

When a taxpayer takes an IRC Sec. 179 deduction, the basis of property subject to MACRS must be reduced by the full amount of the IRC Sec. 179 deduction, even if the taxable income limitation causes part of the IRC Sec. 179 amount to be carried over to a future tax year.

Example 1: Matthew Corp. purchased $259,000 of IRC Sec. 179 qualifying property in 2009. This was the only property placed in service during the year. The taxable income of Matthew Corp. is $35,000, so the amount that can be deducted under IRC Sec. 179 in 2009 is $35,000. The corporation elects to expense the full $250,000 and carry the $215,000 over to the next tax year. The corporation elects not to take bonus depreciation. The corporation will recover the cost of the remaining basis of $9,000 ($259,000 – $250,000) using MACRS rules.

If the taxpayer is unable to expense the full amount under IRC Sec. 179 because more than $2 million was placed in service during the year, only the amount allowed after the phase-out reduces basis.

Example 2: Matthew Corp. purchased $823,000 of IRC Sec. 179 qualifying property in 2009. This was the only property placed in service during the year. The corporation elects not to take bonus depreciation. The corporation is $23,000 over the $800,000 limit for additions, so the amount that can be expensed under IRC Sec. 179 is $227,000 ($250,000 – $23,000). Taxable income is only $7,000, so the maximum amount that can be deducted is $7,000. The company can elect to expense $227,000 and carry $220,000 over to the next tax year. The corporation will recover the cost of the remaining basis of $596,000 ($823,000 – $227,000) using MACRS rules.

Converting from Personal to Business Use

If property held originally for personal use is converted to business use **or** for use in the production of income, basis is the **lesser** of the following (Reg. Sec. 1.167(g)-1; IRC Sec. 168(b)(4)):

- The fair market value of the property on the date changed from personal use.
- The original cost or other basis:
  - Increased by the cost of any permanent improvements or additions and by any other costs that must be added to basis, **and**
  - Decreased by any tax deductions for casualty losses and other charges to basis claimed on earlier years' income tax returns.

The depreciation allowance is determined as though the property was placed in service on the date of conversion. Thus, the taxpayer can choose any depreciation method, recovery period and convention described under IRC Sec. 168.

Example 3: In 2001, Nia paid $160,000 to have her home built on a lot that cost $10,000. In 2003, she paid $18,000 to add a bedroom and bath. This year, Nia converts the personal residence to a rental property. Her adjusted basis in the house at that point is $178,000 ($160,000 + $18,000). On the date of change in use, her property has a fair market value of $180,000 ($30,000 for the land and $150,000 for the house).

The basis for depreciation on the house is the fair market value on the date of change ($150,000) because it is less than her adjusted basis of $178,000. The $28,000 decline in value of the house is treated as a nondeductible personal loss since it occurred before the conversion to business use. Land is not depreciable, but its basis at conversion must be measured to determine gain or loss on a subsequent disposition. Nia's basis in the land would be $10,000 (the lesser of her basis of $10,000 and the fair market value of $30,000).

(IRS Pub. 946, adapted)

Example 4: Nia's adjusted basis in the house at conversion was $178,000 ($160,000 + $18,000). Her basis in the land was $10,000. Assume that, at conversion, her property has a fair market value of $280,000 ($50,000 for the land and $230,000 for the house).

Under these facts, the basis for depreciation on the house is her adjusted basis ($178,000) because it is less than the fair market value on the date of change ($230,000). Her basis for determining gain or loss on a disposition of the land is still $10,000.

(IRS Pub. 946, adapted)

If property is used for both personal and income-producing purposes, a deduction is permitted only for the portion of the property used to produce income.

Example 5: J.J. uses her computer 80% for business and 20% for personal activities. The computer cost $14,000. Her recoverable basis is $14,000 × .80 = $11,200.

If the business-use to personal-use ratio changes in a subsequent tax year, the depreciable basis also changes.

Luxury Automobiles

MACRS places a cap on the annual depreciation deduction for passenger automobiles. This is generally referred to as the luxury car limit.

A passenger automobile is any four-wheeled vehicle that is manufactured primarily for use on public streets, roads, and highways and is rated at 6,000 pounds unloaded gross vehicle weight or less (IRC Sec. 280F(d)(5)(A)(ii)).

Weight cannot be increased when the vehicle is “stretched” or customized to the owner’s specifications by certain specialty manufacturers.

Passenger Automobile Limits

For 2010, the limitation on first-year depreciation is based on a cost of $15,300 (not much luxury there), which is adjusted annually for inflation. The 2010 limit is $3,060, which is a $100 increase from 2009. The limit for light trucks and vans is higher, as you will see.

Note: The Small Business Jobs Act of 2010 extended the $8,000 increase in the first-year depreciation limit for qualifying passenger automobiles. When the special bonus depreciation is claimed (not elected out of), the limit for 2010 is $11,060.

If the 2008 Economic Stimulus Act had not reinstated additional first-year depreciation, the 2008 total depreciation amount for a passenger automobile (including the IRC Sec. 179 deduction) would have been $2,960. The Act increased this limitation by $8,000. As noted earlier, additional first-year depreciation was extended through December 31, 2009. There was no adjustment to the basic amount for 2009. Therefore, the maximum limit is increased to $10,960 for automobiles for which the special bonus depreciation allowance is claimed for both 2008 and 2009. Otherwise, the limit is $2,960.

Prior to the reintroduction of bonus depreciation, the 2008 total depreciation amount for a light truck or van (including the IRC Sec. 179 deduction) was $3,160. The Act increased this limitation by $8,000. Therefore, the maximum limit for 2008 was $11,160 for light trucks and vans for which the special bonus depreciation allowance was claimed. For 2009, the limits for light vans were decreased to $3,060 and $11,060. For 2010, the limits are $3,160 and $11,160.

Reminder: While SUVs that weigh more than 6,000 pounds are not subject to limitations on depreciation itself, IRC Sec. 179 expensing is limited to $25,000. (This was discussed in Lesson 6.)

Example 6: A new car that cost $25,000 is subject to the passenger auto limitations and is placed in service in October 2010. It is the only equipment acquired, so it is MACRS 5-year property and the mid-quarter convention applies. The vehicle is used 100% for business and no amount is expensed under IRC Sec. 179 and bonus depreciation was not taken. Regular depreciation is $1,250 ($25,000 × .05). The auto limit is $3,060. The taxpayer deducts the smaller of the two amounts.

The IRC Sec. 280F limit applies to regular depreciation, IRC Sec. 179 expensing and bonus depreciation. If the car is used less than 100% for qualified business and investment use, the limit is multiplied by the percentage of business and investment use.

A car must be depreciated using the alternative depreciation system (ADS) if its qualified business use is not greater than 50% of total use. ADS was covered earlier; for now, just note that for cars, this means straight-line over 5 years.

Example 7: A new car that cost $35,000 that is subject to the passenger auto limitations is placed in service in May 2010. It is the only equipment acquired, so it is MACRS 5-year property and the half-year convention applies. The vehicle is used 45% for business, thus IRC Sec. 179 expensing and bonus depreciation are not available. Regular depreciation is $1,575 (($35,000 × .45) × .10). The IRC Sec. 280F limit is $1,377 ($3,060 × .45). The final deduction is $1,377.

The cost recovery ceilings are as follows for passenger automobiles (remember that this does not include light vans and trucks) (IRC Sec. 280F):

Year Placed in Service	Maximum Cost Recovery in Tax Year:			
	First	Second	Third	Fourth and Later
2010	$3,060	$4,900	$2,950	$1,775
2009	$2,960	$4,800	$2,850	$1,775
2008	$2,960	$4,800	$2,850	$1,775
2007	$3,060	$4,900	$2,850	$1,775
2006		$4,800	$2,850	$1,675
2004–2005	—		$2,850	$1,675
2003–1995	—	—	—	$1,775

Note: The Small Business Jobs Act of 2010 extended the first-year depreciation limit for qualifying automobiles ($8,000 for 2010).

If the auto is used less than 100% for business purposes, the amounts listed must be prorated. If the car was placed in service in 2010, and the car was used 60% for business, the maximum deduction for 2010 would be $1,836 ($3,060 × .60).

Example 8: In July 2010, Sally Brown purchased an automobile to be used 100% in business. This is the only asset she placed in service during the tax year. The automobile cost $36,000. The depreciation under the general depreciation system (GDS) for Year 1 would be $7,200 ($36,000 × .20). See Table A-1.

Because the IRC Sec. 280F limit is $3,060, Sally's deduction is $3,060. Her Year 2 deduction is limited to $4,900. Furthermore, she must manually calculate depreciation rather than rely on the tables, since they assume she deducted the full $7,200 in the first year.

In most cases, the manual calculation will exceed the ceiling so it is not necessary to do the math. The calculation is ($36,000 – $3,060) × .40 = $13,176, but the actual deduction would be limited to $4,900. Beware that if the car's cost is close to $15,000, it may be necessary to double-check the manual calculation.

IRC Section 280F Limits for Trucks and Vans under 6,000 Pounds in Weight

The method of calculating this price inflation amount for trucks and vans placed in service in or after calendar year 2003 uses a different consumer price index (CPI) component than the one used in the calculation for other passenger automobiles, so the limits are higher for trucks and vans. For this purpose, the term **trucks and vans** refers to passenger automobiles that are built on a truck chassis, including minivans and sport utility vehicles (SUVs) that are built on a truck chassis (Rev. Proc. 2007-30, 2007-18, IRB 1104, April 13, 2007).

Year Placed in Service	Maximum Cost Recovery in Tax Year:			
	First	Second	Third	Fourth and Later
2010	$3,160	$5,100	$3,050	$1,875
2009	$3,060	$4,900	$2,950	$1,775
2008	—	$5,100	$3,050	$1,875
2007	—	—	$3,050	$1,875
2006	—	—	—	$1,875
2004-2005	—	—	—	$1,875
2003	—	—	—	$1,975

Note: The Small Business Jobs Act of 2010 extended the $8,000 increase in the first-year depreciation limit for qualifying passenger automobiles.

Modified Light Trucks and Vans Now Excluded from IRC Section 280F

Excluded property now includes any truck or van under 6,000 pounds in weight that is a qualified nonpersonal use vehicle as defined under Temp. Reg. Sec. 1.274-5T(k).

> The substantiation requirements of IRC Sec. 274(d) and this section apply generally to any pickup truck or van, unless the truck or van has been specially modified with the result that it is not likely to be used more than a *de minimis* amount for personal purposes. For example, a van that has only a front bench for seating, in which permanent shelving that fills most of the cargo area has been installed, that constantly carries merchandise or equipment, and that has been specially painted with advertising or the company's name, is a vehicle not likely to be used more than a *de minimis* amount for personal purposes. (Temp. Reg. Sec. 1.274-5T(k)(7)

The IRS explanation of Temp. Reg. Sec. 1.274-5T(k) makes it clear that the modifications must be sufficient to greatly reduce the likelihood of personal use. It states that the provision only applies to trucks and vans that have been specially modified, such as by installation of permanent shelving and painting the vehicle to display advertising or the company's name, so that they are not likely to be used more than a *de minimis* amount for personal purposes. These specially manufactured or modified vehicles must not provide significant elements of personal benefit. Therefore, a taxpayer is unlikely to purchase one of them unless motivated by a valid business purpose that could not be met with a less expensive vehicle [TD 9069 (July 3, 2003)].

Passenger automobiles like SUVs that are built on a truck chassis would probably be covered by this provision, but the modifications would have to include a lot more than simply painting the company logo on the door to meet the requirements of Temp. Reg. Sec. 1.274-5T(k)(7).

Electric passenger automobiles

The IRC Sec. 280F limits are tripled for electric passenger automobiles placed in service after August 5, 1997, and before January 1, 2007. Owners of electric vehicles placed in service after December 31, 2006, should use the passenger automobile limits or truck and van limits—whichever applies. The electric passenger automobile limits are not available after December 31, 2006.

If the car is used less than 100% for qualified business and investment use, the limit is multiplied by the percentage of business and investment use.

Year Placed in Service	Fourth and Later Tax Years
2006	$5,225
2004–2005	$5,125
2003	$5,225
1999–2002	$5,325
1997 and 1998	$5,425

The Energy Tax Incentives Act of 2005 added several credits for purchasers or lessors of alternative fuel vehicles. These credits are included in IRC Sec. 30B and are effective for property placed in service after December 31, 2005. See IRS Form 8910, *Alternative Motor Vehicle Credit*.

Listed Property

Listed property is equipment that is not used in a regular business setting. Listed property includes property used for transportation or entertainment and certain computers.

If listed property is not used predominantly (greater than 50%) in a qualified business use, the IRC Sec. 179 deduction is not available **and** depreciation must be calculated using ADS (straight-line method) over the ADS recovery period. There are additional rules and recordkeeping requirements that must be followed when depreciating listed property.

An improvement that is made to listed property that must be capitalized is treated as a new item of depreciable property. The recovery period and method of depreciation that apply to the listed property as a whole also apply to the improvement.

Listed property used for transportation includes trucks, buses, boats, airplanes, motorcycles and any other vehicles used for transporting persons or goods (Reg. Sec. 1.274-5T(k).

The following vehicles are not listed property:

- Clearly marked police and fire vehicles
- Unmarked vehicles used by law enforcement officers if the use is officially authorized
- Ambulances 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, refrigerated trucks, combines, cranes, derricks and forklifts

- Passenger buses with a capacity of at least 20 passengers that are used as passenger buses
- Qualified moving vans and specialized utility repair trucks
- School buses, if substantially all the use of the bus is in transporting students and employees of schools
- Tractors and other special-purpose farm vehicles

Computers and related peripheral equipment are **not** listed property if they are used only at a regular business establishment and are owned or leased by the person operating the establishment. A regular business establishment includes a portion of a dwelling unit if that portion is used both regularly and exclusively for business and qualifies for an office-in-home deduction.

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

The following are neither computers nor related peripheral equipment:

- Typewriters
- Calculators
- Adding and accounting machines
- Copiers
- Duplicating equipment
- Equipment used primarily for the user's amusement or entertainment, such as video games

Note: In accordance with the Small Business Jobs Act of 2010, cell phones are removed from the definition of listed property under IRC Sec. 280F, for tax years beginning after December 31, 2009.

Listed property meets the predominant-use test for any tax year if its qualified business use is more than 50% of its total use. The use of any item of listed property employed for more than one purpose during the tax year must be allocated among its various uses.

The predominant-use test must be met for each tax year.

Method of Allocating Use

For passenger automobiles and other means of transportation, allocate the property's use on the basis of mileage.

For other items of listed property, allocate the property's use on the basis of the most appropriate unit of time. For example, determine the percentage of business use of a computer by dividing the number of hours the computer is used for business purposes during the year by the total number of hours the computer is used for **all** purposes during the year.

Note: Investment use of listed property is **not** qualified business use to determine the percentage of business use. You combine business and investment use to determine the cost basis subject to depreciation.

Reminder: Listed property must be employed predominantly (more than 50%) in a qualified business use to:

- Take an IRC Sec. 179 deduction,
- Depreciate the property using any method other than ADS (straight-line method), or
- Qualify for additional first-year depreciation.

Important: The required use of the straight-line method for an item of listed property that does not meet the predominant-use test is not the same as electing the straight-line method. It does not mean that you have to use the straight-line method for other property in the same class as the item of listed property.

Example 9: Sarah owns a home computer located in her bedroom. Sarah's computer is listed property because it is not used at a regular business establishment.

She uses the computer 50% of the time to manage her investments and 40% of the time in her consumer research business. The remainder (10%) of her use is personal. Only the use in the consumer research business is qualified business use.

Since Sarah does not use the computer more than 50% for qualified business use, it does not meet the predominant-use test. She cannot elect an IRC Sec. 179 deduction for this property and she must depreciate it on a straight-line basis (ADS).

Her combined business and investment use for determining her depreciation deduction is 90%.

(IRS Pub. 946, adapted)

Example 10: If Sarah uses her computer 20% of the time to manage her investments and 60% of the time in her consumer research business, her property meets the predominant-use test. She can elect an IRC Sec. 179 deduction and use accelerated depreciation (GDS). Her combined business and investment use for determining her depreciation deduction is 80%.

(IRS Pub. 946, adapted)

Qualified business use is any use in a trade or business. It does **not** include the following:

- The use of property held merely to produce income (investment use).
- The leasing of property to any 5% owner or related person (to the extent that 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 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 where required.

Note: The use of a vehicle for commuting is **not** qualified business use whether or not work is performed during the trip.

A 5% owner of a corporation is any person who owns, or is considered to own, **either**:

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

A 5% owner of a business, other than a corporation, is any person who owns more than 5% of the capital or profits interest in the business.

Any use by employees of their own (or rented) listed property as employees is not business use unless the use is both:

- For the employer’s convenience, and
- Required as a condition of employment.

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

Whether the use of listed property is required as a condition of employment must be determined from all the facts. A statement by the employer that the use of the property is a condition of employment is **not** sufficient. The use of property must be required for the employee to perform duties properly.

Example 11: Virginia is employed by a local courier service. She owns and uses a motorcycle to deliver packages to downtown offices. Her employer explicitly requires all delivery persons to own a small car or motorcycle for use in their employment. Virginia’s use of the motorcycle is for the convenience of her employer and is required as a condition of employment.

(IRS Pub. 946, adapted)

Example 12: Bill is an inspector for a construction company with many sites in the local area. He must travel to these sites on a regular basis. His employer does not furnish an automobile or explicitly require him to use his own automobile. It pays him for any costs he incurs in traveling to the various sites. Bill’s use of his own (or rental) automobile is for the convenience of his employer and is required as a condition of employment.

Important: If Bill’s employer furnishes a car but Bill chooses to use his own car and receive payment for using it, the use of Bill’s own car is **neither** for the convenience of his employer **nor** required as a condition of employment.

(IRS Pub. 946, adapted)

Example 13: David is employed as an engineer. He occasionally takes work home at night rather than work late in the office. He owns and uses a home computer that is listed property because it is not used at a regular business establishment. His use of the computer is neither for the convenience of his employer nor a required condition of employment.

Apply the predominant-use test on an item-by-item **and** on a year-by-year basis.

Important: If the predominant-use test is not met in the first year, accelerated depreciation cannot be used at any time. If the use drops to 50% or less in any subsequent tax year, the taxpayer must switch to the straight-line method and may have to recapture excess deductions.

Example 14: On July 1, James Wand bought and placed in service a computer (5-year property) that cost $4,000. James's computer is listed property because it is not used at a regular business establishment. This is the only asset placed in service during the year.

During the year, he employs the computer 40% for qualified business use, 30% for investment purposes (to produce income), and 30% for personal use. Since the qualified business use is only 40%, he cannot elect any IRC Sec. 179 deduction and must use ADS to figure depreciation.

Under ADS, James figures his depreciation deduction for the year using the straight-line method over the ADS 5-year recovery period following these steps:

1. Determine the business and investment portion of the property cost; multiply the total cost by the combined business-use and investment-use percentage ($4,000 × .70 = $2,800).
2. Multiply the combined business and investment portion of the cost by the straight-line rate (1/5 in this example) adjusted for the appropriate modifying convention (half-year in this example).
3. First-year cost recovery is $280 ($2,800 × .20 × 0.5).

It is not sufficient that a taxpayer meets the predominant-use test in the first tax year. Usage must be tracked and the predominant-use test must be applied each year.

If the taxpayer fails to use listed property more than 50% in qualified business uses in any subsequent tax year, there are two consequences:

1. The taxpayer must switch to the straight-line method in the year the predominant-use test is not met.
2. The taxpayer must recognize any **excess** depreciation as ordinary income (this includes any bonus depreciation taken).

Excess depreciation exists if the amount of depreciation allowable for the property (including any IRC Sec. 179 deduction claimed) for tax years when the predominant-use test is met **exceeds** the amount of depreciation that would have been allowable for those years if depreciation had always been taken on a straight-line basis and the IRC Sec. 179 deduction and bonus depreciation had not been elected.

Example 15: On June 25, 2008, Ellen purchased and placed in service a pickup truck that cost $38,000. She used it only in a qualified business use for 2008 and 2009. Because the pickup truck weighed over 6,000 pounds, it was not subject to the passenger automobile limits.

Ellen claimed an IRC Sec. 179 deduction of $38,000 in 2009. If, during 2009, she used the truck only 50% for business, she would have had to include $26,600 of excess depreciation in gross income. The excess depreciation would have been determined as follows:

Total IRC Sec. 179 deduction and depreciation claimed		$38,000
Depreciation allowable on straight-line basis over five years (half-year convention):		
2008: 10% of $38,000	$3,800	
2009: 20% of $38,000	7,600	11,400
Excess depreciation		$26,600

Changes in Use

In this section you will learn how to deal with the conversion of personal-use property to business or income-producing use, the conversion of MACRS property to personal use, and changes in the taxpayer's use of MACRS property that causes the recovery period or depreciation method to change.

This section will introduce the regulations that deal with how to depreciate property when the use changes in the hands of the same taxpayer. These regulations were finalized in June 2004 and apply to any change in use of MACRS property in a taxable year ending on or after June 17, 2004.

Changes in use include:

- The conversion of personal-use property to business or income-producing use,
- The conversion of MACRS property to personal use, and
- Any changes in the taxpayer's use of MACRS property that result in a different recovery period or depreciation method.

From Business or Income-producing Use to Personal Use

A conversion of MACRS property from business or income-producing use to personal use would be treated as a disposition of the property. Depreciation for the year of change would be computed by taking into account the applicable convention, as with any other disposition. The proposed regulations state that no gain, loss or depreciation recapture under IRC Sec. 1245 or IRC Sec. 1250 is recognized at the time of conversion.

The provisions of IRC Sec. 1245 or IRC Sec. 1250 apply to any subsequent disposition of the converted property (Reg. Sec. 1.168(i)-4(c)).

From Personal Use to Business or Income-producing Use

Personal-use property converted to business or income-producing use would be treated as being placed in service by the taxpayer on the date of the conversion. This conversion would include depreciable property that was used by a tax-exempt entity before it changed to a taxable entity.

The depreciable basis of the property would be the same as discussed earlier: the lesser of its fair market value or adjusted basis at the time of the conversion.

The depreciation allowance would be determined as if the property was placed in service by the taxpayer on the conversion date. Therefore, the taxpayer could choose any applicable depreciation method, recovery period and convention for the property consistent with the rules in effect that year (Reg. Sec. 1.168(i)-4(6)).

Example 16: Anne, a calendar-year taxpayer, purchased a house in 1985 that she occupied as her principal residence. In February 2010, she converted it to residential rental property. At the time of the conversion, the house's fair market value (excluding land) was $130,000 and its adjusted depreciable basis was $150,000.

Anne is considered to have placed residential rental property in service in February 2010 with a depreciable basis of $130,000. She depreciates the residential rental property under the general depreciation system (GDS) using the straight-line method, a 27.5-year recovery period, and the mid-month convention. The depreciation allowance for the house for 2010 is $4,137 ($130,000 adjusted depreciable basis multiplied by the applicable depreciation rate of 3.636% (1/27.5) multiplied by the mid-month convention fraction of 10.5/12).

Property-use Change Resulting in Different Recovery Period or Method

Use Changes in the Tax Year in Which the Property Is Placed in Service

For all changes in use not previously listed, the depreciation allowance would be determined by the primary use of the property during that tax year. The primary use may be determined in any reasonable manner that is consistently applied by the taxpayer.

A change in the use of MACRS property occurs when a taxpayer begins or ceases to use MACRS property predominantly outside the United States during the taxable year. If the property is used both within and outside the United States during the placed-in-service year, the predominant-use test of Reg. Sec. 1.48-1(g)(1)(i) would govern how the depreciation allowance for the placed-in-service year is calculated.

The depreciation allowance for the placed-in-service year for MACRS property that **changes to tax-exempt, bond-financed property** during that taxable year is determined under the alternative depreciation system (ADS). If the MACRS property is **tax-exempt–use property or imported property** covered by an executive order during the placed-in-service year, the use of the property at the end of the placed-in-service year would determine the depreciation method for the placed-in-service year.

Use Changes in a Tax Year after the Property Is Placed in Service

This rule applies to MACRS property that, after its initial year of depreciable use:

- Begins or ceases to be used predominantly outside the United States,
- Results in a reclassification of the property due to a change in the use of the property, or
- Begins or ceases to be tax-exempt–use property.

The depreciation allowance for the year of change is determined as though the use of the property changed on the first day of the year of change.

Election to Stay with the Old Method

When the change in use leads to a shorter recovery period or a faster depreciation method, the taxpayer can elect to continue to use the slower cost recovery method or start a new recovery period using the remaining adjusted basis for the property. In many cases, simply continuing the old method will be the faster way to recover the remaining cost of the property. For example, if a conversion in Year 5 causes 7-year property to revert to 5-year property, it is generally better to continue under the old system for the remaining four years than to start over with a new 5-year recovery period.

The taxpayer elects to stay with the original method by claiming on his timely filed return (including extensions) for the year of change the depreciation allowance for the property as though the change in use had not occurred. A revocation of this election is a change in method of accounting to which the provisions of IRC Secs. 446(e) and 481 apply.

Shorter Recovery Period and/or Accelerated Depreciation Method

The depreciation allowance is computed as follows:

- The property is depreciated beginning with the year of change as though the property is **first** placed in service in the year of change.
- The cost recovery basis is the adjusted depreciable basis of the property as of the first day of the taxable year in which the change occurs.
- The taxpayer may choose any applicable depreciation method and recovery period for the MACRS property in the year of change, consistent with any related elections made for that year.
    - The applicable convention is the same one that applied before the change in the use of the MACRS property:
        - If the taxpayer does **not** use the tables, the first-year deduction is determined without applying the applicable convention, unless the property is disposed of during the year of change.
        - If the taxpayer used the tables, the modifying convention will apply in the year of change since the tables automatically make that adjustment.
    - If the year of change is less than 12 months, the depreciation allowance must be adjusted for a short taxable year as discussed in Lesson 6.

Note: For purposes of determining whether the mid-quarter convention applies to **other** property placed in service during the year of change, the converted property is **not** taken into account. The applicable convention that applies to the converted MACRS property is the same as the convention that applied before the change in the use. The modifying convention, however, is not applied to the depreciation calculation unless the MACRS property is disposed of during the year of change or the taxpayer chooses to use the tables.

Example 17: Change in Use Results in a Shorter Recovery Period and/or a More Accelerated Depreciation Method. A calendar-year corporation placed in service, in 2005, equipment that cost $100,000. The company depreciated the equipment for 2005 through 2009 under the general depreciation system (GDS) as 7-year property using the 200%-declining-balance method and half-year convention. Beginning in 2010, the corporation changed the primary use of the equipment and its classification changed from 7-year property to 5-year property. On January 1, 2010, the adjusted depreciable basis of the equipment was $22,311.

Example 18: The corporation could elect to disregard the change in use and continue to treat the equipment as though it was still 7-year property. If the election is made, the corporation's allowable depreciation deduction for the equipment for 2010 through 2012 continues to be calculated as before the change in use. In that case, the depreciation deduction for 2010 would be $8,920 ($100,000 × .0892) and the deduction for 2011 would be $8,930 ($100,000 × .0893). (These percentages came from the 7-year column of Table A-1, Appendix A1.) The remaining cost would be fully recovered in 2012.

If the election is not made, the corporation's allowable depreciation deduction for the equipment for 2010 and subsequent taxable years is determined as though the corporation placed the equipment in service in 2010 using the 200%-declining-balance method and a 5-year recovery period. The depreciable basis of the equipment as of January 1, 2010, is $22,311.

(Reg. Sec. 1.168(i)-4(d)(6), Examples 1 & 2, adapted)

Manual Calculation

To continue the example, if the corporation does not use the optional depreciation tables, the depreciation allowance for 2010 is computed without taking into account the half-year convention.

For 2010, the corporation's allowable depreciation deduction is $8,924 ($22,311 adjusted depreciable basis at January 1, 2010, multiplied by the applicable depreciation rate of 40% (1/5 × 2)).

Note: Since the tables are not being used, the taxpayer does not have to apply the modifying convention.

For 2011, the depreciation deduction is $5,355 ($13,387 adjusted depreciable basis at January 1, 2010, multiplied by the applicable depreciation rate of 40% (1/5 × 2)). It will take three more years to fully recover the remaining cost.

Calculation Using the Tables

If the corporation chooses to use the optional depreciation table for the equipment, the corporation must identify the appropriate table for the equipment (Table A-1,in the Appendix) because the equipment will be depreciated in the year of change under the general depreciation system (GDS) using the 200%-declining-balance method, a 5-year recovery period, and the half-year convention that applied to the equipment in 2005.

For 2010, the corporation multiplies its adjusted depreciable basis in the equipment ($22,311) by the annual depreciation rate for Recovery Year 1 of 20%, to determine a depreciation allowance of $4,462.

For 2011, the corporation multiplies its adjusted depreciable basis in the equipment as of January 1, 2008, of $22,311, by the annual depreciation rate for Recovery Year 2 of 32%, to determine the depreciation allowance of $7,140.

Note: With the tables, it will take another four years to fully recover the remaining cost of the property.

Longer Recovery Period and/or Slower Depreciation Method

Computation of Depreciation Allowance

The property is depreciated beginning with the year of change as though the property was **originally** placed in service with the longer recovery period and/or slower depreciation method. Therefore, the new recovery period will be the new recovery period **minus** the years before the change.

The applicable convention is the same one that applied before the change in the use. There is no need to use the modifying convention unless the year of change is also a disposition year since the year of change is not considered the first year the property is placed in service.

The cost recovery basis is the adjusted depreciable basis of the property as of the first day of the taxable year in which the change occurs. If the year of change is less than 12 months, the depreciation allowance must be adjusted for a short tax year.

No election to use old method: In this case, the taxpayer must change to the new method. There is no provision for an election to remain with the old method.

Adjusting the Table Percentage

Once again, the taxpayer can choose to use the tables or do a manual calculation. The table percentages are intended to be applied to the original unadjusted basis of the property. For the conversion year, the taxpayer must switch to the remaining adjusted depreciable basis of the property.

Therefore, the percentage in the table needs to be adjusted to reflect the fact that the percentage is being applied to a smaller number. The proposed regulations refer to this adjustment as the **transaction coefficient**.

The product of the annual depreciation rate and the transaction coefficient is multiplied by the adjusted depreciable basis of the MACRS property as of the beginning of the year of change to calculate the annual deduction.

Calculating the Transaction Coefficient

The transaction coefficient is the formula (1 ÷ (1 – x)) where x equals the sum of the annual depreciation rates from the applicable table for the taxable years beginning with the placed-in-service year of the MACRS property through the taxable year immediately **prior** to the year of change.

For example, assume that the property was originally recovered using the 5-year column of Table A-1 (Appendix A1) and the only change is to increase the recovery period to seven years, and the change occurs in Year 4 when the remaining adjusted depreciable basis of the property was $40,000.

The **x** in the formula would be the sum of the table rates for Years 1 through 3, so **x** is .5627 (.1429 + .2449 + .1749) and the transaction coefficient is 2.380 (1 ÷ (1 – .5798)). To calculate the depreciation deduction for Year 4 ($11,426), you would multiply the adjusted basis at the beginning of the year of change ($40,000) by .2856 (.1249 × 2.287). In each subsequent year, you would multiply the $40,000 by the correct table percentage times 2.287.

Determining the Applicable Depreciation Method

The applicable depreciation method for the year of change is the method that would have applied in the year of change had the taxpayer used that method from the date the property was originally placed in service.

For example, the property may have originally been treated as 200%-declining-balance and the new method is 150%. If the 150% method would have switched to the straight-line method in the year of change or any prior year, the applicable depreciation method beginning with the year of change is the straight-line method; otherwise, the 150% would apply.

Determining the Applicable Recovery Period

If the applicable method after the change is either the 200% or 150% method, the new recovery period is the longer of the original recovery period and the change recovery period.

If the applicable depreciation method is straight-line, the recovery period is the number of years of the longer recovery period remaining as of the beginning of the change year. If the recovery period did not change as a result of the change in use, the applicable recovery period is the number of years remaining as of the beginning of the change year.

Remember to count from the year the property was originally placed in service and to adjust for the applicable convention.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

30. Bill King purchases $15,000 of IRC Sec. 179 qualifying property in 2010. This is the only property placed in service during the year. King's taxable income is $188,000. King elects to deduct the maximum amount available under IRC Sec. 179. What is the basis subject to bonus depreciation and cost recovery using MACRS rules?

    a. $0.

    b. $15,000.

    c. $485,000.

31. In 1987, Harry paid $180,000 for a home. The purchase price was allocated as $10,000 for the land and $170,000 for the house. In 1993, Harry took a $10,000 casualty loss deduction for hurricane damage to the house that was **not** covered by insurance. This year, he converted his personal residence to a rental property. On the date of change in use, the property has a fair market value of $200,000 ($60,000 for the land and $140,000 for the house). What is the basis for depreciation on the house at the date of change?

    a. $140,000.

    b. $160,000.

    c. $200,000.

32. On July 2, 2010, Jake spent $56,950 to purchase a passenger automobile that he uses 100% in his business. This is the only asset he acquired during the year, and he has $750,000 of taxable income from his business before this deduction is considered. How much is his deduction related to this car for its first year of operation?

    a. $11,060.

    b. $11,160.

    c. $11,390.

    d. $56,950.

33. Which of the following statements is accurate concerning vehicles placed in service in 2010?

    a. Trucks and vans that are rated at 6,000 pounds gross vehicle weight or less have the same IRC Sec. 280F limit as passenger automobiles.

    b. All four-wheeled vehicles that are manufactured primarily for use on public streets, roads and highways are classified as passenger automobiles for purposes of IRC Sec. 280F.

    c. A limo (originally 5,600 pounds) that was stretched to a new weight of 7,000 pounds can be excluded from classification as a passenger automobile.

    d. The IRC Sec. 280F limit must be prorated if business and investment use is less than 100%.

34. Which of the following statements is accurate concerning listed property?

    a. Computers are always listed property.

    b. All vehicles used for transportation are listed property.

    c. Listed property meets the predominant-use test for any tax year if its qualified business use is more than 50% of its total use.

    d. Investment use of listed property is qualified business use for purposes of the predominant-use test.

35. Jackie has a computer that is used in the following percentages for the following purposes:

    - 20% to work on clients of the CPA firm that is Jackie's employer so Jackie does not have to come to the office on weekends.
    - 30% to work on clients that Jackie serves in her own separate consulting business.
    - 10% to track investment properties.
    - 40% for purely personal purposes.

    What is Jackie's percentage of qualified business use?

    a. 10%.

    b. 30%.

    c. 40%.

    d. 50%.

36. Alexander, Inc. bought a computer this year and placed it in service. During the first year of use, Alexander, Inc. meets the predominant-use test for this listed property. In the following tax year, the predominant use is 45%. What tax consequence does this change in use have for Alexander, Inc.?

    a. No change in depreciation method because the predominant-use test meets the required percentage.

    b. Alexander, Inc. can continue to use accelerated depreciation for their computer.

    c. Alexander, Inc. must switch to the straight-line method and may need to recapture excess deductions.

    d. Alexander, Inc. must switch to the straight-line method and no recapture of excess deductions is required.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

30. Bill King purchases $15,000 of IRC Sec. 179 qualifying property in 2010. This is the only property placed in service during the year. King's taxable income is $188,000. King elects to deduct the maximum amount available under IRC Sec. 179. What is the basis subject to bonus depreciation and cost recovery using MACRS rules? **(Page 97)**

    a. $0. [This answer is correct. The amount that can be deducted under IRC Sec. 179 is $15,000. Therefore, King has no basis left to recover ($15,000 – $15,000) using MACRS rules.]

    b. $15,000. [This answer is incorrect. The basis of property subject to MACRS must be reduced by the amount of the IRC Sec. 179 deduction.]

    c. $485,000. [The IRC Sec. 179 limit for 2010 is $500,000, and only $15,000 of property was placed in service. It is the basis of property subject to MACRS that must be reduced by the amount of the IRC Sec. 179 deduction, not the other way around.]

31. In 1987, Harry paid $180,000 for a home. The purchase price was allocated as $10,000 for the land and $170,000 for the house. In 1993, Harry took a $10,000 casualty loss deduction for hurricane damage to the house that was **not** covered by insurance. This year, he converted his personal residence to a rental property. On the date of change in use, the property has a fair market value of $200,000 ($60,000 for the land and $140,000 for the house). What is the basis for depreciation on the house at the date of change? **(Page 98)**

    a. $140,000. [This answer is correct. The basis for depreciation on the house is the fair market value on the date of change ($140,000) because it is less than his adjusted basis of $160,000 ($170,000 – $10,000). The $20,000 decline in value of the house is treated as a nondeductible personal loss since it occurred before the conversion to business use.]

    b. $160,000. [This answer is incorrect. It is true that the original purchase price must be reduced by the tax deduction relating to the casualty. That amount, however, must be compared to fair market value at conversion.]

    c. $200,000. [This answer is incorrect. The current fair market value of both the house and land is not the depreciable basis at the date of conversion. Land is not depreciable.]

32. On July 2, 2010, Jake spent $56,950 to purchase a passenger automobile that he uses 100% in his business. This is the only asset he acquired during the year, and he has $750,000 of taxable income from his business before this deduction is considered. How much is his deduction related to this car for its first year of operation? **(Page 99)**

    a. $11,060. [This answer is correct. The $3,060 limit under IRC Sec. 280F applies. However, the Small Business Jobs Act of 2010 extended the $8,000 increase in the first-year depreciation limit for qualifying passenger automobiles. Since this amount is smaller than actual depreciation of $11,390, Jake's deduction is limited to $11,060.]

    b. $11,160. [This answer is incorrect. This would be Jake's maximum deduction if his vehicle qualified as a light van and he used it 100% for business.]

    c. $11,390. [This answer is incorrect. This would be Jake's MACRS deduction if he did not elect IRC Sec. 179, elected out of bonus depreciation and he was not limited by IRC Sec. 280F.]

    d. $56,950. [This answer is incorrect. This is Jake's depreciable basis, but IRC Sec. 280F limits prevent him from expensing all of the cost under IRC Sec. 179.]

33. Which of the following statements is accurate concerning vehicles placed in service in 2010? **(Page 100)**

    a. Trucks and vans that are rated at 6,000 pounds gross vehicle weight or less have the same IRC Sec. 280F limit as passenger automobiles. [This answer is incorrect. While trucks and vans that are rated at 6,000 pounds gross vehicle weight or less are covered by IRC Sec. 280F if manufactured primarily for use on public streets, roads and highways, they now have a special classification and a separate IRC Sec. 280F limit from passenger automobiles (IRC Sec. 280F(d)(5)(A)).]

    b. All four-wheeled vehicles that are manufactured primarily for use on public streets, roads, and highways are classified as passenger automobiles for purposes of IRC Sec. 280F. [This answer is incorrect. A passenger automobile is any four-wheeled vehicle that is manufactured primarily for use on public streets, roads and highways and is rated at 6,000 pounds unloaded gross vehicle weight or less. Heavier vehicles are not included (IRC Sec. 280F(d)(5)(A)(ii)).]

    c. A limo (originally 5,600 pounds) that was stretched to a new weight of 7,000 pounds can be excluded from classification as a passenger automobile. [This answer is incorrect. Weight cannot be increased when the vehicle is "stretched" or customized to the owner's specifications by certain specialty manufacturers per IRS laws.]

    d. The IRC Sec. 280F limit must be prorated if business and investment use is less than 100%. [This answer is correct. This is the requirement for automobiles, and light vans and trucks as stated by IRC Sec. 280F.]

34. Which of the following statements is true concerning listed property? **(Page 103)**

    a. Computers are always listed property. [This answer is incorrect. Computers and related peripheral equipment are not listed property if they are 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 if that portion is used both regularly and exclusively for business and qualifies for an office-in-home deduction.]

b. All vehicles used for transportation are listed property. [This answer is incorrect. The following vehicles are not listed property: clearly marked police and fire vehicles and unmarked vehicles used by law enforcement officers if the use is officially authorized, ambulances 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, cement mixers, dump trucks (including garbage trucks), flatbed trucks, refrigerated trucks, combines, cranes, derricks, forklifts, passenger buses (capacity of at least 20 passengers) used as such, qualified moving vans and specialized utility repair trucks, school buses (if substantially all the use of the bus is in transporting students and employees of schools), tractors and other special-purpose farm vehicles per IRS regulations.]

c. Listed property meets the predominant-use test for any tax year if its qualified business use is more than 50% of its total use. [This answer is correct. According to Internal Revenue Code, listed property meets the predominant-use test for any tax year if its qualified business use is more than 50% of its total use. The use of any item of listed property employed for more than one purpose during the tax year must be allocated among its various uses.]

d. Investment use of listed property is qualified business use for purposes of the predominant-use test. [This answer is incorrect. Investment use of listed property is not a qualified business use as stated in Internal Revenue Code. You may combine business and investment use to determine the cost basis subject to depreciation.]

35. Jackie has a computer that is used in the following percentages for the following purposes:

- 20% to work on clients of the CPA firm that is Jackie's employer so Jackie does not have to come to the office on weekends.
- 30% to work on clients that Jackie serves in her own separate consulting business.
- 10% to track investment properties.
- 40% for purely personal purposes.

What is Jackie's percentage of qualified business use? **(Page 104)**

a. 10%. [This answer is incorrect. Investment use of listed property is not a qualified business use since it is a personal use. You do combine business and investment use to determine the cost basis subject to depreciation, though.]

b. 30%. [This answer is correct. On these facts, only the 30% used to service clients that Jackie sees in a separate consulting business counts as qualified business use. Neither the use of the computer to track investments nor the work on the employer's clients is a qualified business use.]

c. 40%. [This answer is incorrect. This is personal use. It does not count as qualified business use and is not part of basis for depreciation.]

d. 50%. [This answer is incorrect. Any use by employees of their own (or rented) listed property as employees is not business use unless both: 1) the use is for the employer's convenience and 2) the use is required as a condition of employment.]

36. Alexander, Inc. bought a computer this year and placed it in service. During the first year of use, Alexander, Inc. meets the predominant-use test for this listed property. In the following tax year, the predominant use is 45%. What tax consequence does this change in use have for Alexander, Inc.? **(Page 106)**

a. No change in depreciation method because the predominant-use test meets the required percentage. [This answer is incorrect. The required percentage for the predominant-use test is more than 45% according to IRS Pub. 946.]

b. Alexander, Inc. can continue to use accelerated depreciation for their computer. [This answer is incorrect. One criteria for not meeting the predominant-use test according to IRS Pub. 946 is that accelerated depreciation cannot be used.]

c. Alexander, Inc. must switch to the straight-line method and may need to recapture excess deductions. [This answer is correct. The predominant-use test is met on an item-by-item and year-by-year basis. Anytime the predominant-use drops to 50% or less, the taxpayer must switch to the straight-line method and may have to recapture excess deductions as stated in IRS Pub. 946.]

d. Alexander, Inc. must switch to the straight-line method and no recapture of excess deductions is required. [This answer choice is incorrect. Per the Internal Revenue Code, the taxpayer must switch depreciation methods and there may be a requirement to recapture excess deductions.]

EXAMINATION FOR CPE CREDIT

Lesson 7

Determine the best answer for each question below. Then log onto our Online Grading Center at **OnlineGrading.Thomson.com** to record your answers.

30. In 1985, Harry paid $80,000 for a home in Texas. The purchase price was allocated as $10,000 for the land and $70,000 for the house. This year, he converted his personal residence to a rental property. On the date of change in use, the property has a fair market value of $100,000 ($16,000 for the land and $84,000 for the house). What is the basis allocated to the land for the purpose of determining gain or loss after the date of change?

    a. $10,000.

    b. $16,000.

    c. $80,000.

    d. $100,000.

31. Lulu uses her computer 85% for business and 15% for personal use. The computer cost $10,000. What is her recoverable basis?

    a. $10,000.

    b. $8,500.

    c. $1,500.

    d. Do not select this answer choice.

32. What is the maximum amount of depreciation allowed for a luxury automobile purchased and placed in service in January 2010, for the first year of operation if its qualified business use is 45%?

    a. $3,060.

    b. $2,960.

    c. $1,683.

    d. $1,377.

33. Ozone, Inc. made an improvement to a listed property that is required to be capitalized. What is the proper treatment of this improvement?

    a. The improvement is treated as a new depreciable property item.

    b. The improvement is added to the basis of the original item.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

34. Flour, Inc. made investment use of listed property. Can Flour include the investment use of the property to determine the percentage of business use for the listed property?

    a. Yes.

    b. No.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

Lesson 8: Amortization of Intangibles

Introduction

In this lesson, you will study the amortization of intangibles.

Learning Objectives

Completion of this lesson will enable you to:

- Compute amortization of start-up and organizational costs and intangible property in general.
- Identify IRC Sec. 197 intangibles.

Amortization of Certain Property

Property can be tangible property that you can see or touch:

- Real property—land and buildings, and generally anything built or constructed on land, or anything growing on or attached to the land
- Personal property—cars, trucks, machinery, furniture, equipment and anything that is tangible except real property

Property can also be intangible property—property that has value but that you cannot see or touch:

- Computer software
- Copyrights
- Franchises
- Patents
- Trademarks
- Trade names

MACRS applies only to tangible property that is:

- Used in a trade or business, or
- Held for the production of income

Intangible property is usually recovered through amortization or depreciation deductions. Amortization is defined as a ratable deduction of the cost of intangible property over its useful life. Some intangibles (such as patents) can, in the right circumstances, be entitled to depreciation. The IRC also contains a few amortization provisions for special classes of otherwise depreciable assets. To further confuse the issue, the terms depreciation and **amortization** are frequently used interchangeably. If the property (goodwill or start-up costs, for example) is entitled only to amortization, the recovery of the basis of the item is probably limited to a straight-line deduction over the amortization period. Some types of intangibles are specifically restricted to the straight-line method when recovery is restricted to amortization.

As noted previously, depreciable intangible property is explicitly excluded from MACRS treatment by IRC Sec. 168(a).

Prior to its amendment in 1990, IRC Sec. 167(c) excluded intangibles from the category of useful-life property that automatically qualified for accelerated depreciation methods such as the 200%-declining-balance method.

IRC Sec. 167 as currently written does not specifically preclude intangibles from the use of any depreciation method as long as the method chosen produces a reasonable allowance. Therefore, under the right circumstances, some intangibles (such as patents) may qualify for recovery under accelerated methods if the taxpayer can make the argument that the method produces a reasonable allowance.

Some expenses paid or incurred after December 31, 2005, and prior to January 1, 2011, in creating or acquiring musical compositions or copyrights to musical compositions can be amortized over a 5-year period instead of being depreciated using the forecast method.

Caution: Under no circumstances can an intangible without a discernible (or legislatively created) useful life be recovered through either depreciation or amortization.

Reg. Sec. 1.167(c) provides that if an intangible asset is known from experience or other factors to be of use in a business or in the production of income for only a limited period (the length of which can be estimated with reasonable accuracy), such an intangible asset may be the subject of a depreciation allowance.

Congress has legislatively created useful lives for certain intangibles such as start-up costs and purchased goodwill. These are discussed later in this lesson.

Some of the more common intangibles are covered in the next few sections. For the next few pages, we will take a look at a few important (but less common) intangibles.

These include bond premiums, leasehold acquisition costs, and software that is not subject to immediate write-off or treated as an IRC Sec. 197 intangible (covered in the last part of this lesson).

Bond Premium

Key Term: A bond is any interest-bearing bond, debenture, note, certificate or other evidence of debt issued by a corporation, government or political subdivision of a government. **Bond premium** is the amount by which basis in a bond purchase exceeds the total of all amounts payable on the bond (other than payments of stated interest).

A purchaser will pay a bond premium if the stated interest paid by the bond exceeds the current market rate available on other debt instruments. The bond premium increases the taxpayer’s basis in the bond that is used to figure gain or loss on the sale or redemption of the bond. Any amortized bond premium reduces the adjusted basis. The premium on tax-exempt bonds must be amortized to reduce the taxpayer’s basis in the bond. The amortizable premium is not a deduction for tax purposes. The premium on taxable bonds can be amortized if the taxpayer elects to do so. If the election is made each year, a ratable part of the premium is used to reduce the amount of taxable interest.

Cost of Getting a Lease

If the taxpayer pays a premium for a lease of business property, the cost is recovered by amortizing it over the term of the lease.

The term of the lease for amortization includes all renewal options (and any other period for which the lessee and lessor reasonably expect the lease to be renewed) if less than 75% of the cost of getting the lease is attributable to the term of the lease remaining on the acquisition date.

Note: The term of the lease remaining on the acquisition date does not include any period for which the lease may later be renewed, extended or continued under an option exercisable by the lessee if the facts do not reasonably suggest such renewal. The regulations state that notice of renewal is tested as a renewal. (Reg. Sec. 1.178-3(a))

Reg. Sec. 1.178-3(c) provides an example where reasonableness of renewal can be construed. The taxpayer constructed a building with a 40-year life on land for which it had a 29-year lease with two 5-year renewal options. The example uses an amortization period of 30 years for the lease premium.

Computer software includes all programs designed to cause a computer to perform a desired function. Computer software also includes any database or similar item that is in the public domain and is incidental to the operation of qualifying software. Payments to lease software are treated as rental payments.

Software acquired after August 10, 1993, that was not acquired in connection with the acquisition of a substantial portion of a business will generally be recovered over 36 months.

Software acquired in connection with the acquisition of a substantial portion of a business can be depreciated over 36 months only if it is not a purchased intangible as defined in IRC Sec. 197 and discussed later in this lesson.

Software acquired in connection with the acquisition of a substantial portion of a business will not be a purchased intangible as defined in IRC Sec. 197 if it meets all of the following requirements:

- It is readily available for purchase by the general public.
- It is not subject to an exclusive license.
- It has not been substantially modified.

Recovering Start-up and Organizational Costs

There are three types of intangibles that must be capitalized that prior to October 22, 2004, had been granted a useful life of 60 months by Congress. The following assets were written off ratably (this means using straight-line) with no salvage value:

1. Certified pollution control facilities that are added to plants that were in service before 1976 (IRC Sec. 169)
2. Business start-up costs (IRC Sec. 195)
3. Corporate and partnership organizational expenditures (IRC Secs. 248 and 709)

Changes Made to Air Pollution Control Facilities

A certified pollution control facility is a facility used to control air or water pollution that is certified by state and federal authorities. For facilities used in connection with any plant or other property that was in operation before 1976, taxpayers can elect to amortize qualified costs over a 60-month period that begins with either the month the facility is completed or acquired or the first month of the next tax year. This rule remains in effect. Only electric generation plants and other properties that are primarily coal-fired are affected by the rule discussed in the next paragraph.

The Energy and Highway Tax Acts of 2005 eliminated the requirement that the plant be in operation before January 1, 1976, but **only for** electric generation plants and other properties that are primarily coal-fired. This new provision applies only to facilities placed in service after April 11, 2005. The amortization period for costs that qualify only under the new rule is increased to 84 months.

Only the portion of the basis attributable to construction, reconstruction, or erection by the taxpayer which is completed after April 11, 2005, qualifies for 84-month amortization. If the taxpayer acquires the facility, the original use of the property must begin with the taxpayer.

Start-up and Organizational Costs after October 22, 2004

The American Jobs Creation Act of 2004 made a major change to the way that start-up costs and organizational costs are recovered. The new rule is applied separately to the two types of costs. The general rule is stated in the rest of this discussion.

If expenditures are $50,000 or less, taxpayers can elect to deduct up to $5,000 in the year in which their trade or business begins. (See the note below for new amounts regarding start-up costs).

The $5,000 amount must be reduced (but not below zero) by the amount by which total costs exceed $50,000.

Any remaining costs **must** be ratably amortized over a 180-month period (15 years).

Partnerships also follow these rules.

Prior to this, these costs were recovered over 60 months.

Note: In accordance with the Small Business Jobs Act of 2010, for a tax year beginning in 2010, the deduction for start-up expenses under IRC Sec. 195 is increased from $5,000 to $10,000 and the phase-out threshold is increased from $50,000 to $60,000. The increase deduction does **not** apply to the deduction for organizational expenditures, which remains at $5,000.

When Does Amortization Start?

For start-up costs, amortization begins with the month in which the active trade or business begins. Taxpayers are generally not treated as being engaged in a trade or business until the business begins to function as a going concern and performs those activities for which it is organized.

For organizational costs, amortization begins with the month in which the corporation begins business. Per Reg. Sec. 1.248-1(a)(3), the determination of the date the corporation begins business presents a question of fact which must be determined in each case in light of all the circumstances of the particular case. The words "begins business," however, do not have the same meaning as "in existence." Ordinarily, a corporation begins business when it starts the business operations for which it was organized; a corporation comes into existence on the date of its incorporation. Mere organizational activities, such as the obtaining of the corporate charter, are not sufficient to show the beginning of business. If the activities of the corporation have advanced to the extent necessary to establish the nature of its business operations, however, it will be deemed to have begun business. For example, the acquisition of operating assets which are necessary to the type of business contemplated may constitute the beginning of business.

Note: The deduction and phase-out level are applied separately to each group of expenses. Therefore, a new company that spent $25,000 in start-up costs and $35,000 in organizational costs in 2010 could deduct $15,000 in total in the first year. In some cases the month in which the active trade or business begins and the month in which the corporation begins business will not be the same. There could be minor differences in how the amortization is calculated for the two categories of expenses.

If No Election, Then What?

If no election was made for costs incurred before September 9, 2008, both start-up and organizational costs had to be capitalized.

Capitalized start-up costs are deductible when a trade or business is completely disposed of by the taxpayer.

Capitalized organizational costs are deductible only when the corporation is terminated and its franchise abandoned.

This rule also applies to any amounts that have not been completely amortized at the time the business is terminated or the corporation is abandoned.

Note: The deemed election rule can be applied to expenditures paid or incurred after October 22, 2004, if the statute of limitations has expired. (Temp. Reg. Sec 1.248-1TCF)

Organization expenses are costs that meet all of the following three criteria:

1. Incident to the creation of the entity
2. Chargeable to a capital account
3. Of a character that, if spent incident to the creation of a partnership or corporation having an ascertainable life, would be amortized over that life

For example, organization expenses include the following:

- Legal fees for services incident to organization of the partnership or corporation, such as negotiation and preparation of a partnership agreement and creation of the articles of incorporation
- Accounting fees for services incident to the organization of the partnership or corporation
- Filing fees

Costs That Cannot Be Amortized as Organization Costs

Syndication expenses connected with the issuing and marketing of interests in a partnership cannot be amortized as organization costs. These include costs such as the following:

- Brokerage fees
- Registration fees
- Legal fees of the underwriter or placement agent and the issuer for securities advice and advice about the adequacy of tax disclosures in the prospectus or placement memorandum for securities law purposes
- Accounting fees for preparation of representations to be included in the offering materials
- Expenditures connected with issuing, selling and redeeming a corporation's stock

IRC Sec. 197 Intangibles

When an existing business is sold, the selling price will usually exceed the total fair market value of the tangible assets listed on the balance sheet. In this case, the purchaser has paid for intangible assets such as goodwill or going concern value.

Prior to the enactment of IRC Sec. 197, goodwill and going concern value could not be amortized since they had no ascertainable useful life. Therefore, buyers would attempt to allocate any excess to assets separate and distinct from goodwill that would have an ascertainable useful life, such as covenants not to compete and customer lists. The IRS fought these allocations and frequently prevailed in court. Then taxpayers won a series of cases in the early 1990s and IRC Sec. 197 was enacted.

IRC Sec. 197 provides that goodwill and certain other intangibles purchased after August 10, 1993 (there was an election available to utilize the provision early), and used in a business or income-producing activity may be amortized over 15 years beginning with the month in which the intangible is acquired. These are generally referred to "as purchased" or "IRC Section 197" intangibles.

There are downsides to IRC Sec. 197 for some taxpayers. All intangibles acquired in the asset purchase must be recovered over 15 years, even if they were separately bargained for and have a shorter economic life than 15 years. Furthermore, no loss deduction is allowed on the disposition or worthlessness of an IRC Sec. 197 intangible until all IRC Sec. 197 intangibles acquired in the same business purchase have been disposed of.

The 15-year amortization applies only if the goodwill or other intangibles are acquired in an applicable asset acquisition, as defined in IRC Sec. 1060. This includes any transfer of assets constituting a trade or business if their character is such that the definition of goodwill or going concern value could, under any circumstances, attach to those assets. It is not necessary that the entire business be transferred—only that a substantial portion of the business assets is part of the transfer.

The 15-year amortization rules also apply to intangibles treated as acquired under an IRC Sec. 338 election to treat the purchase of stock as an asset purchase.

The American Jobs Creation Act of 2004 amended IRC Sec. 197 to permit sport franchises to use these rules.

The following rules should be used in calculating the amortization deduction:

- Amortize the intangible ratably over the 15-year period that begins with the month in which the intangible was acquired (IRC Sec. 197(a)).
- In computing the deduction, property acquired at any time during the month is treated as acquired as of the first day of that month (Reg. Sec. 1.197-1T(b)(7)(i)).
- No amortization deduction is allowed for the month of disposition (Reg. Sec. 1.197-1T(b)(7)(ii)).
- The amortization deduction for a short taxable year is based on the number of months in the short taxable year.

Amortizable IRC Sec. 197 intangibles include the following:

- Goodwill
- Going concern value
- Workforce in place, including its composition and the terms and conditions (contractual or otherwise) of its employment
- Business books and records, operating systems, or any other information base (including lists or other information with respect to current or prospective customers)
- Any patent, copyright, formula, process, design, pattern, know-how, format or other similar item
- Any customer-based intangible
- Any supplier-based intangible
- Any license, permit or other right granted by a governmental unit or an agency or instrumentality thereof
- Any covenant not to compete (or other arrangement, to the extent such arrangement has substantially the same effect as a covenant not to compete) entered into in connection with an acquisition (directly or indirectly) of an interest in a trade or business or substantial portion thereof
- Any franchise, trademark, or trade name

An IRC Sec. 197 intangible does **not** include any of the following:

- Financial interest in a corporation, partnership, trust or estate
- Interest in land
- Computer software that is readily available for purchase by the general public, is subject to a nonexclusive license, has not been substantially modified, and other computer software not acquired in a transaction involving the acquisition of assets constituting a trade or business
- An existing lease of tangible property
- Any right to service indebtedness that is secured by residential real property, unless such right is acquired in a transaction involving the acquisition of assets constituting a trade or business
- Any fees for professional services and any transaction costs incurred by parties to a transaction with respect to which any portion of the gain or loss is not recognized

Key Term: Computer software means any program designed to cause a computer to perform a desired function. Such term shall not include any database or similar item unless the database or item is in the public domain and is incidental to the operation of otherwise qualifying computer software.

Exception: An IRC Sec. 197 intangible does **not** include the following **unless** they are acquired in a transaction purchasing a trade or business or a portion of a business:

- Any interest in a film, sound recording, videotape, book or similar property
- Any right to receive tangible property or services under a contract or granted by a governmental unit or agency or instrumentality thereof
- Any interest in a patent or copyright
- Any right under a contract (or granted by a governmental unit or agency or instrumentality thereof) if such right:
  - Has a fixed duration of less than 15 years, or
  - Is fixed as to the amount and would be recoverable under a method similar to the units-of-production method.

Dispositions of IRC Sec. 197 Intangibles

A loss cannot be claimed when an amortizable IRC Sec. 197 intangible is sold if other IRC Sec. 197 intangibles acquired in the same transaction (or a series of related transactions) are still held by the taxpayer.

The bases of the retained IRC Sec. 197 intangibles are increased by a share of the unrecognized loss. Each retained asset is increased by the product of:

- The amount of the loss that is not recognized, and

- A fraction, the numerator of which is the adjusted basis of the intangible on the date of disposition and the denominator of which is the total adjusted bases of all the retained IRC Sec. 197 intangibles on the date of disposition.

Recapture of IRC Sec. 197 Amortization Modified

The Energy and Highway Tax Acts of 2005 requires a taxpayer who sells IRC Sec. 197 intangibles in a single transaction or series of transactions to determine recapture as if all of the IRC Sec. 197 intangibles were a single asset. As a result, any gain on the sale or other disposition of the intangibles is recaptured as ordinary income to the extent of amortization deductions previously claimed on all of the IRC Sec. 197 intangibles.

The provision applies to dispositions of property after August 8, 2005.

Example 2: The taxpayer acquired two IRC Sec. 197 intangible assets for a total of $75,000 on January 1 several years ago. Intangible 1 was assigned a cost basis of $15,000, and Intangible 2 was assigned a cost basis of $60,000. Annual amortization is $5,000 ($75,000 divided by 15 years). At the end of Year 3, when $15,000 of amortization had been claimed, both assets were sold for a total of $70,000. Under the old rules, whether or not there is any ordinary income recapture would depend on how the $70,000 sales price was allocated.

Under the current rule, recapture is calculated as if the two intangibles were a single asset. The total $10,000 gain ($70,000 – ($75,000 – $15,000)) is ordinary since the two assets had been allowed $15,000 of amortization deductions.

This single asset rule does not apply to any IRC Sec. 197 intangible sold in a group transaction if its adjusted basis exceeds its fair market value.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

37. In 2010, the year in which it began business, B&F Corporation spent $52,000 in start-up costs and $35,000 in organizational costs. Ignoring amortization, how much can the company deduct for start-up and organization costs, combined?

    a. $8,000.

    b. $10,000.

    c. $15,000.

38. B&F Corporation spent $72,000 on organizational costs. It began business on May 1 of this year. What is the company's total deduction for organizational costs in this year?

    a. $72,000.

    b. $5,000.

    c. $3,200.

39. Which of the following are IRC Sec. 197 intangibles that may be amortized over 15 years if acquired after August 10, 1993, in a qualifying purchase?

    a. A franchise.

    b. A partnership interest.

    c. An interest in land.

40. Which of the following statements is true?

    a. The taxpayer purchased a business this year. The taxpayer can elect to amortize the cost of a patent acquired in the transaction over its remaining life.

    b. If the taxpayer purchased a business this year, the taxpayer can elect to amortize the computer software (which is readily available for purchase by the general public, is subject to a nonexclusive license, and has **not** been substantially modified) acquired in this transaction over its actual remaining life.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

37. In 2010, the year in which it began business, B&F Corporation spent $52,000 in start-up costs and $35,000 in organizational costs. Ignoring amortization, how much can the company deduct for start-up and organization costs, combined? **(Page 124)**

    a. $8,000. [This answer is incorrect. B&F would have only been able to deduct $8,000 if they had begun business in 2009 when the limit and threshold for start-up costs were $5,000 and $50,000.]

    b. $10,000. [This answer is incorrect. The total deduction is greater than $10,000 for start-up and organizational costs since the deduction and phase-out limits are calculated separately for each category of cost.]

    c. $15,000. [This answer is correct. B&F can deduct the full $5,000 for organization costs since less than $50,000 was spent on this category. They can also deduct the full $10,000 for start-up costs since the total is under the $60,000 threshold.]

38. B&F Corporation spent $72,000 on organizational costs. It began business on May 1, of this year. What is the company's total deduction for organizational costs this year? **(Page 124)**

    a. $72,000. [This answer is incorrect. The entire amount of organizational costs cannot be written off in the first year per the American Jobs Creation Act of 2004.]

    b. $5,000. [This answer is incorrect. The $5,000 deduction is phased out dollar for dollar if total expenditures exceed $60,000. Therefore, the $5,000 deduction is not allowed, and the full cost must be amortized.]

    c. $3,200. [This answer is correct. The $5,000 deduction is fully phased out, so the full cost must be amortized: $72,000 ÷ 180 = $400. The company was in business for eight months, so the total deduction is $400 × 8 = $3,200.]

39. Which of the following are IRC Sec. 197 intangibles that may be amortized over 15 years if acquired after August 10, 1993, in a qualifying purchase? **(Page 127)**

    a. A franchise. [This answer is correct. Franchises, trademarks and trade names that are purchased by a taxpayer (not self-created) are IRC Sec. 197 intangibles (IRC Sec. 197(d)(1)).]

    b. A partnership interest. [This answer is incorrect. IRC Sec. 197 intangibles do not include any acquired financial interest—partnership, corporation, estate or trust (IRC Sec 197(e)).]

c. An interest in land. [This answer is incorrect. An interest in land would be considered a financial interest in a tangible asset rather than an intangible asset. IRC Sec. 197 intangibles do not include any interest in land (IRC Sec. 197(e)).]

40. Which of the following statements is true? **(Page 128)**

a. The taxpayer purchased a business this year. The taxpayer can elect to amortize the cost of a patent acquired in the transaction over its remaining life. [This answer is incorrect. All intangibles acquired in the asset purchase must be recovered over 15 years, even if they were separately bargained for and have a shorter economic life than 15 years per IRS regulations.]

b. If the taxpayer purchased a business this year, the taxpayer can elect to amortize the computer software (which is readily available for purchase by the general public, is subject to a nonexclusive license, and has not been substantially modified) over its actual remaining life. [This answer is correct. An IRC Sec. 179 intangible does not include any computer software readily available for purchase by the general public that is subject to a nonexclusive license and that was not substantially modified, and any other computer software that is not acquired in a transaction involving the acquisition of assets constituting a trade or business per the Internal Revenue Code.]

EXAMINATION FOR CPE CREDIT

Lesson 8

Determine the best answer for each question below. Then log onto our Online Grading Center at **OnlineGrading.Thomson.com** to record your answers.

35. Which of the following is an example of tangible property?

    a. Trade names.

    b. A computer chip.

    c. Patent for a new computer chip.

    d. Do not select this answer choice.

36. Which of the following is an example of intangible property?

    a. A computer.

    b. A digital camera.

    c. A milk cow.

    d. The rights to a song.

37. On May 5 of the current year, Your Company paid $50,000 for software. This software is not IRC Sec. 197 property. What is the first-year deduction related to this acquisition?

    a. $278.

    b. $2,222.

    c. $11,111.

    d. $16,667.

38. Troy Associates was formed on April 1 of the current year, and has a calendar year-end. It incurred $9,000 of partnership organizational expenditures. What is the total amount that can be deducted and amortized this year?

    a. $5,200.

    b. $5,000.

    c. $1,350.

    d. $450.

39. The calendar taxpayer purchased a business on December 21 of this year and allocated $504,000 to goodwill. What is the allowed amortization for this year for tax purposes?

    a. $33,600.

    b. $16,800.

    c. $2,800.

    d. $1,400.

40. Which of the following intangibles can be amortized over 15 years if purchased as part of a business?

    a. Covenant not to compete.

    b. Proprietary software.

    c. Intangible drilling expense.

    d. Do not select this answer choice.

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Table A-1
3-, 5-, 7-, 10-, 15-, and 20-Year Property
Half-Year Convention—Declining Balance

Depreciation rate for recovery period

Year	3-year	5-year	7-year	10-year	15-year	20-year
1	33.33%	20.00%	14.29%	10.00%	5.00%	3.750%
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

Table A-2
3-, 5-, 7-, 10-, 15-, and 20-Year Property
Mid-quarter Convention
Placed in Service in First Quarter—Declining Balance

Depreciation rate for recovery period

Year	3-year	5-year	7-year	10-year	15-year	20-year
1	58.33%	35.00%	25.00%	17.50%	8.75%	6.563%
2	27.78	26.00	21.43	16.50	9.13	7.000
3	12.35	15.60	15.31	13.20	8.21	6.482
4	1.54	11.01	10.93	10.56	7.39	5.996
5		11.01	8.75	8.45	6.65	5.546
6		1.38	8.74	6.76	5.99	5.130
7			8.75	6.55	5.90	4.746
8			1.09	6.55	5.91	4.459
9				6.56	5.90	4.459
10				6.55	5.91	4.459
11				0.82	5.90	4.459
12					5.91	4.460
13					5.90	4.459
14					5.91	4.460
15					5.90	4.459
16					0.74	4.460
17						4.459
18						4.460
19						4.459
20						4.460
21						0.557

Table A-3
3-, 5-, 7-, 10-, 15-, and 20-Year Property
Mid-quarter Convention
Placed in Service in Second Quarter—Declining Balance

Depreciation rate for recovery period

Year	3-year	5-year	7-year	10-year	15-year	20-year
1	41.67%	25.00%	17.85%	12.50%	6.25%	4.588%
2	38.89	30.00	23.47	17.50	9.38	7.148
3	14.14	18.00	16.76	14.00	8.44	6.612
4	5.30	11.37	11.97	11.20	7.59	6.116
5		11.37	8.87	8.96	6.83	5.658
6		4.26	8.87	7.17	6.15	5.233
7			8.87	6.55	5.91	4.841
8			3.33	6.55	5.90	4.478
9				6.56	5.91	4.463
10				6.55	5.90	4.463
11				2.46	5.91	4.463
12					5.90	4.463
13					5.91	4.463
14					5.90	4.463
15					5.91	4.462
16					2.21	4.463
17						4.462
18						4.463
19						4.462
20						4.463
21						1.673

Table A-4
3-, 5-, 7-, 10-, 15-, and 20-Year Property
Mid-quarter Convention
Placed in Service in Third Quarter—Declining Balance

Depreciation rate for recovery period

Year	3-year	5-year	7-year	10-year	15-year	20-year
1	25.00%	15.00%	10.71%	7.50%	3.75%	2.813%
2	50.00	34.00	25.51	18.50	9.63	7.289
3	16.67	20.40	18.22	14.80	8.66	6.742
4	8.33	12.24	13.02	11.84	7.80	6.237
5		11.30	9.30	9.47	7.02	5.769
6		7.06	8.86	7.58	6.31	5.336
7			8.86	6.55	5.90	4.936
8			5.53	6.55	5.90	4.566
9				6.56	5.91	4.460
10				6.55	5.90	4.460
11				4.10	5.91	4.460
12					5.90	4.460
13					5.91	4.461
14					5.90	4.460
15					5.91	4.461
16					3.69	4.460
17						4.461
18						4.460
19						4.461
20						4.460
21						2.788

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

Depreciation rate for recovery period

Year	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	5.48	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

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

Month property placed in service

Year	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

Table A-7
Nonresidential Real Property
Mid-Month Convention
Straight-Line—31.5 Years

Month property placed in service

Year	1	2	3	4	5	6	7	8	9	10	11	12
1	3.042%	2.778%	2.513%	2.249%	1.984%	1.720%	1.455%	1.190%	0.926%	0.661%	0.397%	0.132%
2-7	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175
8	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.175	3.175	3.175	3.175	3.175
9	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175
10	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174
11	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175
12	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174
13	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175
14	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174
15	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175
16	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174
17	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175
18	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174
19	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175
20	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174
21	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175
22	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174
23	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175
24	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174
25	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175
26	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174
27	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175
28	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174
29	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175
30	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174
31	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175
32	1.720	1.984	2.249	2.513	2.778	3.042	3.175	3.174	3.175	3.174	3.175	3.174
33							0.132	0.397	0.661	0.926	1.190	1.455

Table A-7a
Nonresidential Real Property
Mid-Month Convention
Straight-Line—39 Years

Month property placed in service

Year	1	2	3	4	5	6	7	8	9	10	11	12
1	2.461%	2.247%	2.033%	1.819%	1.605%	1.391%	1.177%	0.963%	0.749%	0.535%	0.321%	0.107%
2-39	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564
40	0.107	0.321	0.535	0.749	0.963	1.177	1.391	1.605	1.819	2.033	2.247	2.461

Table A-8
Optional IRS Generated Depreciation Percentages
3-Year MACRS Property
Subject to Half-Year or Mid-Quarter Convention

Optional IRS generated depreciation percentages for 3-year MACRS property subject to either the half-year or mid-quarter (Mid-qtr) convention

Year	1
Half Year	33.3%
Mid-qtr, 1st qtr	58.33%
Mid-qtr, 2nd qtr	41.67%
Mid-qtr, 3rd qtr	25.00%
Mid-qtr, 4th qtr	8.33%

The table on this screen is taken from the first columns of Tables A-1 through A-5. It shows all of the potential percentages for a 3-year property. The tables are adjusted for the appropriate modifying convention in Year 1. However, if you dispose of property before the cost recovery is complete, you must adjust the table percentage for the appropriated modifying convention.

Optional IRS generated depreciation percentages for 3-year MACRS property subject to either the half-year or mid-quarter (Mid-qtr) convention

	Year 1	**Year 2**	**Year 3**	**Year 4**
Half Year	33.3%	44.45	14.81	7.41
Mid-qtr 1st qtr	58.33%	27.78	12.35	1.54
Mid-qtr 2nd qtr	41.67%	38.89	14.14	5.30
Mid-qtr 3rd qtr	25.00%	50.00	16.67	8.33
Mid-qtr 4th qtr	8.33%	61.11	20.37	10.19

Let's take a look at a few more screens to make sure you understand where the table percentages are coming from. That will make YOUR adjustment for the modifying convention in the year of early disposition easier.

1st quarter	**Year 1**	**Year 2**
% in prior periods	0	58.33%
Method * MC (No MC except year acquired/disposed)	(1 ÷ 3 × 2) × (3.5 ÷ 4) = 58.33%	(1 ÷ 3 × 2) = 66.67%
Remaining basis as a % of original basis	100%	41.67%
Half-year recovery percentage	58.33% (58.33% × 100%)	27.78% (66.67% × 41.67%)

Table A-8 (continued)
Optional IRS Generated Depreciation Percentages
3-Year MACRS Property
Subject to Half-Year or Mid-quarter Convention

The 27.78% is derived by multiplying 66.67% (double the straight-line rate) by the remaining basis of 41.67% (1 - 58.33%). In the second year, you would multiply the original cost of the property by 27.78%. Make sure you remember why the modifying convention is 3.5 ÷ 4. If it is not clear, review Chapter 3.

REMEMBER: You will only have first quarter, mid-quarter property in a year in which you also placed at least 40% (regardless of class) of your property in service in the fourth quarter.

1st quarter	Year 1	Year 2
% in prior periods	0	58.33%
Method * MC (No MC except year acquired/disposed)	(1 ÷ 3 × 2) × (0.5/4) = 8.33%	(1 ÷ 3 × 2) = 66.67%
Remaining basis as a percent of original basis	100%	91.67%
Half-year recovery percentage	8.33% (8.33% × 100%)	61.11% (66.67% × 91.67%)

The 61.11% is derived by multiplying 66.67% (double the straight-line rate; no MC) by the remaining basis of 91.67% (1 - 8.33%). In the second year, you would multiply the original cost of the property by 61.11%. Make sure you remember why the modifying convention is 0.5 ÷ 4. If it is not clear, review Chapter 3.

Glossary

Accelerated Cost Recovery System (ACRS) – Accelerated cost recovery system (ACRS) is a depreciation method specified in the tax law that is applied to assets acquired after 1980 and through 1986. It was replaced by modified ACRS (MACRS). It prescribed asset lives and rates of depreciation for classes of assets.

Established by the Economic Recovery Tax Act of 1981 (ERTA ’81) and changed by the Tax Reform Act of 1986 (TRA ’86), ACRS ignores concepts of useful life and residual value and specifies “cost recovery periods” for various classes of assets that are used as the useful life. It also specifies the percentage of cost allocated to each year. ACRS ignores residual value and provides for rapid recovery of the acquisition cost of operational assets with the public-interest objective of encouraging capital expenditures to modernize existing plant assets.

Alternative Depreciation System (ADS) – The alternative depreciation system (ADS) applies to nonlisted property and uses the **applicable** recovery period, depreciation method and convention.

The following types of property are subject to ADS depreciation rules:

- Tangible personal property used outside the United States
- Property used for tax-exempt purposes (by a tax-exempt group)
- Property financed by tax-exempt bonds
- Imported property regarding which the President of the United States has signed an executive order
- Farm equipment or property placed in service during the year in which an election was made under IRC Sec. 263A(d)(3)

There are also exceptions to other types of property which can be depreciated using ADS if an election is made. This method is similar to but separate from the elections available under the general depreciation methods (MACRS) to elect to use 150% DB or straight-line depreciation over the MACRS lives.

Alternative Minimum Tax (AMT) – The alternative minimum tax (AMT) is designed to prevent taxpayers from escaping a fair share of tax liability by excessive use of certain tax breaks. A taxpayer is subject to this tax if the taxpayer has certain minimum tax adjustments or tax preference items and the alternative minimum taxable income (including adjustment for any net operating loss) exceeds the exemption allowed for the taxpayer’s filing status and income level. The alternative minimum tax is computed on Form 6251 for individuals and Form 4626 for corporations.

Amortization – Amortization is the tax deduction for the cost or other basis of an intangible asset that can be recovered over the asset’s estimated useful life.

Amortizable intangibles include patents, copyrights, and leasehold interests.

Some intangibles, such as organizational costs that have no estimated useful life, are allowed to be amortized over a 180-month period.

RRA '93 (the Revenue Reconciliation Act of 1993) added a method to amortize purchased intangibles (acquired after August 10, 1993, with an election available for purchases made since July 25, 1991). These intangibles are called IRC Sec. 197 intangibles. The purchased intangible is amortized over 15 years beginning with the month of acquisition.

Amortizable IRC Sec. 197 intangibles include goodwill; going concern value; workforce in place; business records and systems; patents and similar items; any customer-based intangible; any supplier-based intangible; any license from a government; any covenant not to compete; and any franchise, trademark, or trade name.

Basis – Basis is the amount used by the taxpayer to compute the amount of gain or loss upon sale or disposition of an asset. In most cases, the basis is the carrying value (acquisition cost plus additions or improvements minus accumulated depreciation).

In most cases, initial basis is the acquisition cost (i.e., fair market value); however, in some cases a new owner uses (assumes) the basis of the asset in the hands of the previous owner (usually lower than fair market value), as with a gift.

Class Life – Class life is the period, specified by the alternative depreciation system (ADS), over which a taxpayer may take depreciation deductions for the alternative minimum tax (AMT) system for tax years prior to 1999.

The class life is generally defined as the asset depreciation range (ADR) midpoint life and is specified for many assets in Rev. Proc. 87-56 and Rev. Proc. 88-22.

Corporation – A corporation is a form of business that is a legal entity separate and apart from its owners. In the United States, corporations may be formed under state law, can sue and be sued, can own property and be taxed, and are responsible for their own debts and torts and the torts of their officers, agents or employees during the course and within the scope of their corporate duties. Owners (shareholders) are subject to limited liability only (i.e., to the extent of their investment). The shareholders annually elect a board of directors to set policy for the corporation. The board appoints officers to carry out the day-to-day management of the corporation. Except for electing directors, the shareholders have no authority to manage the business.

Depreciation – Depreciation is the process of systematic, rational **allocation** of the cost of operational assets to the accounting periods benefited. Depreciation is **not** a process of valuation (ARB 43, Chapter 9C, ¶5), does **not** represent a reserve to replace the asset, and does **not** mean that cash will be available to replace the asset. Depreciation allowed for tax purposes often differs from depreciation allowed for accounting.

Accounting depreciation attempts to match the cost of the asset to the revenues generated over the life of the asset. It represents accrual accounting and has **no effect** on cash flows (a noncash expense). Depreciation expense must be added back to accounting income when reconciling to cash from operations.

Computation of depreciation requires the following:

- Acquisition cost
- Estimated useful life
- Estimated residual (salvage) value

- Depreciation method (four GAAP alternatives):
  1. Straight-line
  2. Sum-of-the-years'-digits
  3. Double-declining balance
  4. Units of production—units of product and machine hours

Factors that cause the need for depreciation include the following:

- Physical factors:
  - Wear and tear
  - Effects of time and other elements
  - Deterioration and decay
- Functional factors:
  - Inadequacy of capacity
  - Obsolescence

Earnings and Profits – Earnings and profits (E&P) is a corporate-level account used to determine the tax status of corporate distributions. The IRC has never specifically defined the term earnings and profits. E&P is computed for each tax year by starting with taxable income and then making the adjustments described in IRC Sec. 312 and the regulations thereunder. It is often referred to as the economic ability of the corporation to pay a dividend. Corporate distributions are taxed as dividends only if made from current or accumulated earnings and profits. Dividends are first considered to have come from current E&P and then from accumulated E&P. Current E&P, although similar to net income, will not be identical. Accumulated E&P, although similar to retained earnings, will not be the same amount. Accumulated E&P is calculated from the later of the date of incorporation or February 28, 1913.

Half-year Convention – The half-year convention means that only half of a year's depreciation is allowed in the year the asset is placed in service and in the year of disposition (IRC Secs. 168(d)(1) and 168(d)(4)(A)).

Under MACRS, the half-year convention is applied to all "personal property" (property other than residential rental property and nonresidential real property) in the year of acquisition and in the year of disposition, unless the mid-quarter convention is required for that tax year.

IRC Section 179 – IRC Sec. 179 is a provision of the tax law that allows the taxpayer to elect to expense up to a certain amount of tangible depreciable personal property placed in service during the year. The basis of the asset(s) is reduced by the amount so expensed. There are two restrictions: The amount expensed cannot exceed the taxpayer's aggregate taxable income from trade or business activities (excess is carried forward indefinitely), and the ceiling amount is reduced dollar-for-dollar for personal property acquisitions in excess of the ceiling. Qualified IRC Sec. 179 property must be acquired by purchase for use in the active conduct of a trade or business.

IRC Section 1250 – IRC Sec. 1250 requires that gain on disposition of real property be treated as ordinary income to the extent of the depreciation claimed in excess of straight-line depreciation. Any gain in excess of this ordinary income is IRC Sec. 1231 gain.

Leasehold Improvements – Leasehold improvements are costs incurred to increase the benefit derived from property which is under an operating lease, e.g., additions, finish-out, parking areas, upgrades to facilities, etc.; are intangible, identifiable, inseparable assets (because the property to which the improvements are attached does not belong to the entity); and are amortized, usually straight-line, over the shorter of the useful life of the improvement or the remaining lease term.

For tax purposes, under MACRS rules the recovery class of the improvement is the same as that of the underlying property. The recovery period that applies to the class is used, without regard to the remaining term of the lease.

Note: Under the Tax Extenders and Alternative Minimum Tax Relief Act of 2008, 15-year straight-line cost recovery is allowed through 2009.

Luxury Automobile – A luxury automobile is a business-use automobile that has a fair market value in excess of a statutory maximum. For the 2010 tax year, the maximum is $15,300. The maximum amount sets a cap on the modified accelerated cost recovery system (MACRS) deductions available during the statutory recovery period of the automobile. For example, if a $20,000 vehicle is purchased for exclusive business use, the cost recovery deduction in the first year will be limited to the amount available to a $15,300 car, or $3,060 (5-year recovery period using the half-year convention and 200% declining balance depreciation or 20% in the first year). Subsequent recovery deductions are also computed based on this statutory ceiling. If the car is maintained in business use for a sufficiently long period of time, the entire purchase cost will be recovered. The luxury automobile rules, however, stretch out the recovery period, typically beyond the time that an automobile is normally kept.

For 2010, if the vehicle qualifies for the additional bonus depreciation allowance and no election out is made, the limit for the first-year depreciation allowance is $11,060.

Mid-quarter Convention – A mid-quarter convention is applied to all property (other than residential rental property and nonresidential real property) placed in service if more than 40% of the **aggregate** basis of all property placed in service during the year is placed in service during the last three months of the year. For tax years beginning after March 31, 1988, property placed in service and disposed of during the same tax year is **not** included in the 40% test.

Modified Accelerated Cost Recovery System (MACRS – The modified accelerated cost recovery system (MACRS) is a depreciation method specified in the tax law applied to assets acquired after 1986. MACRS replaced ACRS (accelerated cost recovery system) and prescribes asset lives and rates of depreciation for classes of assets.

Nonresidential Real Property – Nonresidential real property is rental property not used as a residence. It has a recovery period of 39 years under MACRS. Typical examples include office buildings and warehouses.

Patent – A patent is the exclusive right granted by a government to an inventor to use, sell, manufacture, or control the invention for a specified period of time. A patent is an intangible asset that is identifiable and separable, may be purchased or developed internally, and has a legal life of 17 years (useful life may realistically be shorter than 17 years). Patents are recorded at cost and amortized straight-line over the shorter of the useful life or 17 years.

Real Property – Real property is land and anything erected or growing on or permanently attached to the land (immovables), such as land, buildings, and growing trees, which includes the surface, air rights, and the contents of the land.

Real property may be converted into personal property by severance (sand, growing trees, and minerals). Personal property may be converted into realty (fixture) by attachment, such as the construction of structures like buildings, roads, bridges, and fences using cement, bricks, lumber, a central air conditioning or heating system, and so forth.

Residential Rental Property – Residential rental property is a building or structure that derives at least 80% of its gross rental income from dwelling units. The term "dwelling unit" means a house or apartment used to provide living accommodations in a building or structure but does not include a hotel, motel, or other establishment where more than one-half of the units are used on a transient basis. (IRC Sec. 168(e)(2)(A))

Retirement Payments—Partners – All payments to a retiring partner in excess of **property** payments are classified as IRC Sec. 736(a) payments and referred to as **retirement payments**. This includes payments for a partner's share of unrealized receivables and **may** include payments for goodwill.

Retirement payments under IRC Sec. 736(a) are treated as either **guaranteed payments** or **distributive shares** of partnership income. Although both are taxed as ordinary income, the significance of classifying payments as either guaranteed payments or distributive shares is that the character and timing of the income to the retiring partner may differ. In addition, the tax consequences to the remaining partner may differ depending upon classification.

IRC Sec. 736(a) payments are treated as guaranteed payments subject to IRC Sec. 707(c) if they are made without regard to the partnership income. Payments classified as guaranteed payments generally are deductible by the partnership and reported as ordinary income by the partner. A retiring partner that is entitled to the guaranteed payment must include the payment in ordinary income in the taxable year that includes the partnership's taxable year in which the partnership deducts the payments.

IRC Sec. 736(a) payments are treated as a distributive share of partnership income and loss if computed with regard to partnership income. A payment treated as a distributive share to a retiring partner reduces proportionately the distributive share of partnership income to be reported by the remaining partners. Because certain items of partnership income and deductions are required to be taken into account separately, the retiring partner is treated as receiving a share of each item of income and loss of the partnership under IRC Sec. 702.

Salvage Value – Salvage value is the amount estimated to be recoverable on disposal (by sale, trade-in, or other means) or retirement from service of an operational asset (net of any costs of disposal, such as dismantling and selling expenses). The remaining carrying amount, after deduction of salvage value, is then fully depreciated (depreciated to the end of the asset's useful life).

Start-Up Costs – Start-up costs are the costs to begin the operation of a business—usually the costs of capital assets, initial development of a market, and costs of production prior to the time that sales are achieved.

The accounting treatment for these costs is capitalization (as “start-up costs,” which are different from “organizational costs”), provided there is a future benefit and recoverability of the costs and amortization over a period of not less than 60 months.

SFAS 7 (*Accounting and Reporting by Development Stage Enterprises)* – For tax purposes, a taxpayer who enters the trade or business can elect to amortize these expenses over a period of not less than 60 months, starting with the month that business begins. The 60-month amortization period is not available for start-up costs incurred after October 22, 2004. Instead, taxpayers can elect to deduct the first $5,000 (reduced by start-up costs in excess of $50,000). The balance of the start-up costs is amortized over 180 months.

Tangible – “Tangible “ means having physical substance. It is capable of being seen, held, or used (e.g., cash, inventories, land, buildings, equipment, and furniture) and is in contrast to intangible assets.

Cash and deposits, accounts receivable, investments in equity securities, and prepaid expenses are **intangible** assets in the **strictest** sense of the term. Due to the short-term nature and easily determined value of these assets, however, accounting treatments are fairly straightforward and well defined. These assets are usually included in discussions of tangible assets and are **not** considered “intangible assets.”

Units-of-Production – Units-of-production is a depreciation method based on the assumption that useful life decreases with production output rather than with the passage of time. The output can be measured as units of output or machine hours used. Depreciation expense varies with production. A proportionate part of cost is allocated to each unit of production.

The computation is: rate per unit = (cost – residual value) ÷ useful life (in units).

Depreciation expense = rate per unit × units of output, current year

The advantages of this method are that it is simple and uses actual output. The disadvantage is that depreciation expense varies each year.

Useful Life – Useful life is the measurement of the benefit derived from the use of an operational asset, which may be measured in terms of time, units of production, or time of production (machine hours).

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