Depreciation—A Brief Discussion

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Introduction

This discussion is meant to be brief and is no way to be construed as extensive or all-inclusive. The level of discussion is just beyond Basics. We will be hitting the highlights only, and as with all complex topics, the Tax Preparers must be doing their own research as it applies to their clients' situation.

Background on Depreciation as a Tax concept

SIXTEENTH AMENDMENT

The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

Before 1913, when Federal Income Tax became law under the 16th amendment, depreciation for tax purposes didn't exist. Once the great capitalists started paying taxes on their profits, they began to look around for tax deductions and tax loopholes. One of their arguments was that they were providing buildings and equipment at great expense so that people could have jobs, so they should be able to deduct the cost of these very expensive items. They were successful.

Depreciation affects many areas of the tax return. We will discuss a few of them.

Ah, Ma, do I HAVE to take Depreciation?

Yes, Son, you do.

26 US Code Scn 1402. Definitions

Scn 1402(a) **Net Earnings From Self-Employment.** The term "net earnings from self-employment" means the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this subtitle which are attributable to such trade or business,…

Rev. Rul. 56-407 held that under SCN 1402(a) every taxpayer (with the exception of certain farm operators) must claim all allowable deductions in computing net earnings from self-employment for self-employment tax purposes.

This ruling applies to earned income for calculating Earned Income Tax Credit. This eliminates finding the EITC sweet spot by plugging and removing figures.

Additional information—this would also apply to manipulating profit in order to get a mortgage.

See the Form 4797 Page 2 which uses the terms Depreciation Allowed or Allowable.

To be depreciable, an asset must:

1) be property you own * See leased inclusion amount below after Auto Mileage
2) be used in your trade or business or income-producing activity
3) have a determinable useful life
4) Must last more than one year

Conversions from Personal Use Assets to Business Use Assets

While you cannot depreciate personal use assets that are not used in your trade or business, you can start depreciating them, when they are converted to business use. Basis for depreciation is the lower of your costs or the fair market value (FMV) at the time of conversion.

The home you bought on June 10, 1995 and used personally until November 11, 2018 when it was converted to rental use, may have a different basis depreciation and/or for capital gain later.

FMV at time placed in service	House	$ 150,000
June 10, 1995	Land	50,000
	Total	$ 200,000
FMV at time of conversion	House	$ 100,000
November 11, 2018	Land	100,000
	Total	$ 200,000

The depreciable basis of this home at time of conversion is $100,000.

Property Tax Statements are good sources of fair market value ratios, even if the dollar amounts are not up to date.

To the original basis, add some of the costs of purchase settlement and any capital improvements made before conversion.
Subtract any tax deductions taken for casualty and theft losses which reduce the basis. (The Casualty and Theft Losses except for Presidentially declared disaster areas are no longer taken on the Schedule A as of 2018).

Some Varieties of Depreciation

Straight Line—Originally, the total costs of getting the item into service, Less Salvage Value, Divided by the number of years expected to be in service.

Machine cost $7,000 including labor to install it. Expected to be used for 7 years and having a salvage value of $2,000 at the end of its useful life.

$5,000/7 years would be $714.29 per year.

Depreciable Basis for a house did not include value of land as that was considered the ultimate salvage value. There was no prescribed life for assets so one company could take depreciation of a house over 40 years, another 25 years etc. There was no level playing field. Current reasoning is that we don't have to consider Salvage Value.

Enter the CLADR Tables which outline the expected lives of classes of assets. This gave a systematic way of measuring lives of assets. Although they weren't necessarily accurate. These are now named ***Table of Class Lives and Recovery Periods.*** They define asset classes, describe the assets included, give the Class Life (in

Years), show the General Depreciation System (GDS) and MACRS recovery period, and the Alternate Depreciation System (ADS) recovery period.

150% Straight Line Declining Balance – Accelerated Depreciation

This method calculates the depreciation each year by dividing the remaining basis by the years left and multiplying this straight line figure by 150%. Salvage value is not considered.

For example: 7 year property $7,000

Year 1	$7,000 divided by 7 =	$1000 x 1.50 = $1500	
Year 2	$5,500 divided by 6 =	$917 x 1.50 = $1375	
Year 3	$4125 divided by 5 =	$825 x 1.50 = $1238	
Year 4	$2887 divided by 4 =	$722 x 1.50 = $1083	
Year 5	$1804 divided by 3 =	$601 x 1.50 = $ 902	
Year 6	$ 902 divided by 2 =	$451 x 1.50 = $ 677	sub-total $6775
Year 7	$ 225	$ 225	
	Total Depreciation	$7,000	

Sum-of-the-Years-Digits Method of Depreciation – Accelerated Depreciation

Under the sum-of-the-years-digits method of depreciation, changing fractions are applied each year to the original cost or other basis, less salvage value. The numerator of the fraction each year represents the remaining useful life of the asset. The denominator, which remains constant, is the sum of the numerals representing each of the years of the estimated useful life (the sum-of-the-years digits). The taxpayer may elect this method for group classified, or composite accounts. (Reg.Scn 1.167(b)-3).

For example, a machine costing $10,000 with a life of 5 years, and a salvage value of $2,000 would have the following depreciation calculation:

Year 1 = 5/(1+2+3+4+5) =	5/15 = .33	x $8,000 = $2666	
Year 2 = 4/15 = .27	.27	x $8,000 = $2160	
Year 3 = 3/15 = .20	.20	x $8,000 = $1600	
Year 4 = 2/15 = .13	.13	x $8,000 = $1040	sub-total taken $7,466 bal $534
Year 5 = 1/15 = .07	.07	x $8,000 = $ 534	was $560, it had reached the limit
Total depreciation taken		$8000	

Straight-line would have been $8,000/ 5 years or $1,600 per year.

Percentage of Useful Life - This is neutral as to acceleration.

A copy machine costing $7,500 is expected to last for 200,000 copies. Each year a different number of copies are used.

Year 1 copies used	10,000	10/200 = .05 x $7,500 =	$ 375
Year 2 copies used	30,000	30/200 = .15 x $7,500 =	$1125
Year 4 copies used	50,000	50/200 = .25 x $7,500 =	$1875
Year 5 copies used	20,000	20/200 = .10 x $7,500 =	$ 750
Year 6 copies used	60,000	60/200 = .30 x $7,500 =	$2250
Year 7 copies used	30,000	30/200 = .15 x $7,500 =	$1125
Total copies	200,000	Total depreciation	$7500

ACRS- Accelerated Cost Recovery System –

In 1980, there was a recession going on and in order to stimulate the economy, Senator Bob Packwood of Oregon, decided the tax benefit of “quickly” depreciating new assets would be enough to cause business people to buy business assets. The useful lives would be 3, 5, 10, 15, 18, or 19 year property. Personal property fell into the 3, 5, 10, or 15 years class.
Residential Rentals and low-income housing fell into the 15 year recovery period from January 1, 1981 through March 16, 1984.
Then after March 15, 1984 and before May 9, 1985 the recovery period was 18 years.
For real property placed in service after May 8, 1985 and before January 1, 1987 the recovery period was 19 year. ACRS lasted from January 1, 1981 through 1986.

Non-residential real property had a class life of 31.5 years.

The Half-year Convention was used regardless of the life expectancy for personal property. No deduction was allowed for the year personal property was disposed of.

During this time, Straight-Line could be chosen as a method of depreciation.

There were prescribed charts starting with the description of the recovery periods and the month placed in service. The current Publication 946, *How to Depreciate Property*, does not include these ACRS tables.

MACRS – Modified Accelerated Cost Recovery System

When the economic stimulus of ACRS didn’t go as planned, MACRS was put into place. MACRS rules changed the prescribed life of assets and the timing of when to take the MACRS depreciation.

MACRS for personal property is considered Accelerated, while MACRS for real estate is considered straight-line.

Refer to the spreadsheet Table showing the comparison of Straight-Line to MACRS for 5 year property and 27.5 year property. This shows that MACRS for real estate Section 1250 property is straight-line and not accelerated. The 5 year personal property is Section 1245 property and is accelerated.

Publication 946 has most of the information you always wanted to know about depreciation and probably more.

Auto Mileage with the Depreciation Component

Chart for Depreciation as a Part of Standard Mileage Rate

Year	Business Rate	Depreciation Component
2013	56.5	23
2014	56.0	22
2015	57.5	24
2016	54.0	24
2017	53.5	25
2018	54.5	25

For example, a $35,000 car bought and placed in service in 2013 and using 8,000 business miles per year would have the following depreciation reducing its basis by the end of 2018.

2013 8000 x .23 = 1840
2014 8000 x .22 = 1760
2015 8000 x .24 = 1920
2016 8000 x .24 = 1920
2017 8000 x .25 = 2000
2018 8000 x .25 = <u>2000</u>
Total depreciation $ 9440
Total Business Miles 48000
Adjusted Basis of Car $25560 at end of 2018.

As of 2018 Like-kind exchanges only pertain to real property. Thus trade-in basis for basis, in general, no longer applies to purchase and sale of a business auto.

If each year the owner drove 10,000 total overall miles for the year, that totals 60,000 miles.

If the car sold for $30,000, the gain would be $4440. This is fully taxable.
If the car sold for $20,000, a personal loss cannot be deducted, but the business loss can. The overall loss is $4460. 48,000/60,000 = .80 so the business loss on the **Form 4797** is $3568.

*Leased Inclusion Amount

See ***Publication 463, Travel, Gift, and Car Expenses*** for additional details.
Leasing a luxury automobile for business requires using a chart to calculate the Leased Inclusion Amount which essentially reduced the portion of the lease that would be allocated to depreciation. This was to be included in income by reducing the deduction for the lease payment
Prior to 2018 A luxury vehicle was one that cost over $15,000.
In 2018 the threshold for luxury passenger automobiles was set at $50,000. This Chart is reflected in Appendix C-1 of Pub 463. The chart shows values from $ 51,000 to $100,000 and the amounts for each year to add back to leasing costs.

Prior year Inclusion amounts for Passenger vehicles are shown in Appendixes A-1 through A-4.
Appendixes B-1 through B-4 show the inclusion amounts for trucks or vans.

For example, a passenger vehicle leased in 2018 for $60,000 and used 75% for business would have a first year amount from the chart C-1 of $26. Multiplied by 75%, the inclusion amount of $20 would reduce the lease payment deduction.

Talk about Trades, what about the Scn 1031 Exchange (Starker or Non-Taxable Exchange) as it relates to depreciation?

The basis in the old property given up becomes the basis in the new property acquired. To this is added any un-like property applied to the new property such as Cash down, additional mortgage, other kinds of property and improvements. But the life does start over from the date placed in service.
And as stated above, the Scn 1031 exchange applies only to Real Estate starting in 2018.

Tax treatment on sale or disposition of business use Items that were (or weren't) subject to depreciation

Form 4797 *Sale of Business Property*
What is this Section 1231, 1245, 1250, 1251, and 1252 Property?

Let's do the 4797 Dance:
Holler "1231", Stomp, stomp the floor to indicate land
Holler "1245", Slap the table to indicate personal business use property
Holler "1250", Slap the wall to indicate real property improvements

Upon sale, these properties have different tax treatments.
Examine the sections of the Form 4797.
Part I is Long-term (held more than 1 year). This is where we enter the gain or loss from the sale of land that has not been depreciated. This land is Scn 1231 property.
(Some computer tax softwares are having trouble separating the different sections of assets.)
Part II is Short-term and is treated as ordinary income.

Part III Gains from Disposition of Property under Sections 1245, 1250, 1252, 1254, and 1255.

Notice that **Line 22** asks for Depreciation (or depletion) allowed or allowable. Refer to Section 1402(a) above.
Line 25 is for depreciation taken on Section 1245 Property. Since this is accelerated depreciation it is recaptured as ordinary income. Section 1245 property is defined as any new or used tangible or intangible personal property that **has been or could have been** subject to depreciation or amortization.

Line 26 asks for Section 1250 property depreciation. MACRS on real property is considered straight-line so there is no recapture of accelerated depreciation required. Assets that were in ACRS and pre-ACRS would be subject to recapture, if accelerated depreciation over straight-line had been taken.

Section 1250 property is depreciable real property such as commercial buildings, warehouses, barns, rental properties, and their structural components (if depreciated separately).

Section 1251 (not listed separately here). Section 1251 has to do with farm recapture property and is beyond the scope of this discussion.

Section 1252 property is farmland held less than 10 years on which soil, water, or land-clearing expenses were deducted.

Section 1253 is not part of this discussion, but it refers to Transfers of franchises, trademarks, and trade names.

Section 1254 property refers to natural resource recapture property such as oil, gas, or geothermal property.

Section 1255 property refers to gain from Disposition of Scn 126 Property. The adjusted basis of the property is affected by the fair market value of Certain Cost-sharing Payments regarding Wetlands Reserve Program, the Environmental Quality Incentives Program , and the Wildlife Habitat Incentives Programs. The Cost-share payments received under the programs are eligible for exclusion from gross income to the extent permitted by Scn 126.

Form 4562 *Depreciation and Amortization*

Form 4562 is the summary of the current depreciation and amortization expenses. It is included with the tax return, while the worksheets showing the depreciation schedules is not included.

Part 1 shows the Election to Expense Certain Property Under Section 179.
See the Section 179 part to tell what the limits are for this form. Most computer software fills this in for you.
Part 2 shows the Special Depreciation Allowance and Other Depreciation. Note: this includes the old ACRS depreciation.
Part 3 Section A. MACRS Depreciation for assets placed in service in a prior year. If the only reason you would have to use the Form 4562 is to report this, then you don't have to fill it in or send it in.
Part 3 Section B. Assets Placed in Service During 2018 Tax Year Using the General Depreciation System.
This is a summary of assets by class total.
Part 3 Section C. Assets Placed in Service During 2018 Tax Year Using the Alternative Depreciation System.
This is a summary of assets by class total.

All assets in a class must use the same depreciation method in the year placed in service. Different classes may have different treatments.

Part 4 Summary. But wait there's more. Turn the page over
Part 5 Listed Property including automobiles etc.
Part 6 Amortization
Often times when we are reconciling the Income statement for sole proprietors, partnerships, S Corporations, or C corporations, we find the apparent difference is in depreciation. If there is still a discrepancy, look at Amortization, which can show up in the list of other expenses.

Depreciation Strategies

While the rules for each class and class life are fairly regulated, there is some choice as to how to take the depreciation.

Bonus Depreciation Scn 168 (k)(10)

This is chosen by default. You elect out of taking this, should you not want to take advantage of it.
The bonus rate for property acquire before September 28, 2017 is 50%, if placed in service before 2018.
The bonus rate is 40% in 2018, and 30% in 2019.
There is no taxable income or investment limitation on the bonus depreciation allowance.
There is also no limit on the total amount of bonus depreciation that may be claimed on qualifying property.

Section 179 for Sole Proprietors, Partnerships, S Corporations

Notice that this title doesn't include an estate, trust, and specified non-corporate lessor.

Other taxpayers may elect to expense the cost of qualifying section 179 property placed in service during the tax year rather than treating the cost as a capital expenditure.
The election is made on Form 4562, *Depreciation and Amortization.*

2018 Limitations
Maximum Scn 179 election $1 million
Investment Limitation for total Scn 179 property costs placed in service for the year $2.5 million
Taxable Income Limitation—Total Cost of Scn 179 election cannot exceed the total amount of taxable income from the activity during the year including salary and wages received as an employee.
For Married Filing Joint Taxpayers, this can include the spouse's income or W2 wages.

Amounts unused due to income limitations are carried forward indefinitely.

The basis in the asset is reduced by the amount of the Scn 179 election even if a portion of the elected amount is disallowed as a deduction due to the Income Limitation.

There are special rules for real property and leasehold improvements. These rules change frequently so they need to be researched on a case by case basis.

Listed Property

Business Usage required for Listed Property: at least 50%.
Listed property includes passenger autos, other forms of transportations (if it could be used for personal use) entertainment, recreational and amusement property, computers and peripheral equipment if placed in service before 2018.
If business use of listed property falls below 50%, the Scn 179 expense must be recaptured. This is reported on Form 4797 page 2.
Computers and related peripherals are not listed property if placed in service after 2017.

The Scn 179 expensing cap on SUVs, Trucks, and Vans Exempt from Luxury Car Depreciation Caps is $25,000.

Gain on sale of property subject to the Scn 179 expense is treated as Scn 1245 property. Thus it is taxed as ordinary income.

De Minimus Safe Harbor Expensing

Under Reg 1.263(a)-1(f), A taxpayer may elect to expense items and not capitalize them, subject to limits.
The election is made on tangible property.
If the taxpayer has an applicable financial statement (AFS), the limit is $5,000 per item.
If the taxpayer does not have an AFS, the limit is $2,500 per item. (Listed separately on the invoice).

Treatment on company books, financial statements, and the tax return should match. Procedures for accounting for this election should be written and in place at the beginning of the year, for businesses with the AFS. The rule is similar for businesses without an AFS, but the procedures don't have to be written.

The de minimus election must be made on a timely filed return including extensions. The election is made by attaching a statement to the return.

The statement should include the name of the business, the year of the election, the election to make the De Minimus Safe Harbor expense under Reg 1.263(a)-1(f), and a description of the types of property for this choice, and the Dollar amount of the expensed items.

Author's note: this could make county personal property tax audits difficult unless there is some record of what has been expensed over the years.

Who gets the Scn 179 expenses for a Sub S or Partnership?
Since Scn 179 expenses flow through to the shareholders/members of Sub S corporations and partners of Partnerships, it may be advantageous to assess the benefits of the types of depreciation and the timing of them in the year placed in service. De Minimus Safe Harbor and other Depreciation methods stay within the tax return of the organization.

Office –in-Home or Business Use of Home on Form 8829.

More information on Business use of your Home is found in Pub 587.
Business use of home must be exclusive and regular use. As of 2018, employee expenses for business use of the home is no longer allowed.

Reporting actual costs of running the home including depreciation may be more currently beneficial than the Safe Harbor method (also known as the simplified method). The Safe Harbor Method is taking $5 per square foot (maximum 300 square feet) of business use space. The Safe Harbor Method does not require recovery of depreciation taken when the home is sold.

Office in Home Depreciation is calculated over 39 year life. (For residential rental home-offices, in the rental, the life is 27.5 years)

Depreciation taken reduces the basis in the home. The amounts of depreciation taken do not count for the Scn 121 exclusion of gain. This part of the gain is treated as capital gain subject to capital gains tax.

For example:

Purchase price of home including land	$200,000
Depreciation taken on Form 8829	13,000
Adjusted basis in home	$187,000
Net sales price	$437,000

Gain	$250,000 normally this would be excluded under Scn 121.
Depreciation not excluded	13,000 reported as capital gain on Form 4797
Excludable portion of gain	$237,000

Amortization Usually under Scn 197

Amortization is usually a form of "depreciating" intangible assets. Examples are goodwill, going concern value, covenants not to compete, workforce in place, information base, patent, copyright, formula design, any customer-based intangible, any supplier-based intangible, any license, permit, or other right granted by a governmental unit or agency, and any franchise, trademark, or trade name.

Mostly these have to be acquired in connection with a trade or business. Self-produced intangibles are generally not amortized under Scn 197.

Goodwill is amortized over 15 years.
Start up costs can be expensed up to $5,000. With total costs being less than $50,000. The balance is amortized over 15 years.

For residential rental property mortgages costs and settlement costs, are generally amortized over the life of the loan. The same is true for re-financing.

Depletion

This is the allowance for the using up of natural resources such as oil and gas or minerals.
There are two methods: Cost depletion and percentage depletion.

The **cost** calculation is a quotient of the basis in the reserve divided by the number of units estimated to be in the deposit. Each year the cost basis of the property is reduced, but not below zero.

The **percentage** depletion may be used for most types of natural resources. It does not include timber. The percentage is calculated by a flat percentage of gross income from the property. In case of oil or gas property it cannot exceed 50% of the taxable income from the property without regard to the depletion allowance, the deduction for domestic production activities deduction. and any QBI deduction after 2017. The limit for oil and gas is 100% of the taxable income.

Depreciation as it relates to QBI or QBID and the Section 199 (a)

This is not a discussion of Qualified Business Income (QBI). It is only about the mention of depreciation in calculating the limitations on the Qualified Business Income Deduction.

The deductible amount of the QBI for each trade or business of the taxpayer is generally limited to the LESSER of:

- 20 % of the taxpayer's share of the business's W2 wages; or
- a wage/capital limit that is the GREATER of:
    - 50 % of the taxpayer's share of the business's W2 wages
    - 25% of the taxpayer's share of the business's W-2 wages,
      plus 2.5% of the taxpayer's share of the business's unadjusted basis in qualified property immediately after acquisition (UBIA).

The W-2 wages capital limit does not apply If the taxpayer's taxable income is less than the threshold amount. $315,000 if MFJ and $157,500 for all other taxpayers.

UBIA property is not affected by depreciation deductions, tax credits, or expense elections. It is reduced by non-business use of the property.

UBIA property must :

1) Be used in the trade or business of the taxpayer.
2) Be available for use before the end of the taxyear.
3) NOT have its depreciable period end before the close of the tax year (not fully depreciated).
4) NOT have higher than a 10 year life after the placed in service date

In other words, this looks like business use personal property in most cases.

Form 3115 *Application for Change in Accounting Method*

A Change in depreciation from an inacceptable method to an acceptable Method is a change that requires permission from the IRS and the filing of the Form 3115.

There are several pages in the Form 3115 that do not apply to changes in depreciation. There are several types of changes in accounting methods, but for this discussion, we are concerned only with depreciation.

Section 481(a) adjustment is recorded on the current related tax form or as a positive (increase in net income) or a negative amount (decrease in net income). If the adjustment is negative it can be taken in the current year. A negative adjustment is recorded in the current year. A positive adjustment is recorded in the current year if the adjustment is less than $50,000. A positive adjustment of more than $50,000 can be taken over 4 years.

Other errors such as math errors or posting errors are not considered a change in accounting method. These can be amended up to the limit of open years. Form 3115 may be filed on a timely filed amendment. In general, the Form 3115 must be filed in the current year in which the change should be made.

Let's examine the Form 3115 that is shown in the appendix. The example will be for a correction in depreciation.

Summary

Working with depreciation can be overwhelming the first time. With experience, it becomes less challenging. With more experience, the arguments for and against a certain method can be quite interesting. We don't argue on opinions, we argue on Section Codes. Even though some of the taxpayers will not like our decisions, it is part of our job to educate the clients. Thank you for participating in this discussion.

Sources:
2019 U.S. Master Tax Guide, multiple sites
Internal Revenue Service, examples of forms and instructions
Internal Revenue Service, Publications
- 946 *How to Depreciate Property*
- 535 Business Expenses
- 463 *Travel, Gift, and Car Expense*
- 587 *Business Use of Home*

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