Chapter 7

Depreciation, Cost Recovery, Amortization, and Depletion

Eugene Willis, William H. Hoffman, Jr., David M. Maloney and William A. Raabe

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Cost Recovery

- Recovery of the cost of business or income-producing assets is through:
  - Cost recovery or depreciation: tangible assets
  - Amortization: intangible assets
  - Depletion: natural resources
General Considerations
(slide 1 of 2)

• Basis in an asset is reduced by the amount of cost recovery that is allowed or allowable
General Considerations
(slide 2 of 2)

• ACRS & MACRS apply to:
  – Assets used in a trade or business or for the production of income
  – Assets subject to wear and tear, obsolescence, etc.
  – Assets must have a determinable useful life
  – Assets that are tangible personalty or realty
Accelerated Cost Recovery System-Personalty

• ACRS (1981-1986) characteristics:
  – Statutory lives of 3, 5, 10, 15 years
  – Assets have no salvage value
  – Mid-year convention
  – Reduce depreciable basis by 1/2 investment tax credit taken
MACRS-Personalty

- **MACRS (after 1986) characteristics:**

<table>
<thead>
<tr>
<th>MACRS Personalty</th>
</tr>
</thead>
<tbody>
<tr>
<td>Statutory lives:</td>
</tr>
<tr>
<td>Method:</td>
</tr>
<tr>
<td>Convention:</td>
</tr>
</tbody>
</table>

  DB = declining balance with switch to straight-line
  Straight-line depreciation may be elected
Additional 30% Cost Recovery Allowance

- For qualified property acquired after 9/10/01 and before 9/11/04, an additional 30% cost recovery allowance is available
  - Qualified property includes most types of new property other than buildings
  - Additional 30% cost recovery taken reduces adjusted basis of property
  - May elect to not take the additional first-year cost recovery
Example - Additional 30% Cost Recovery Allowance

• Corporation acquires new five-year property for $10,000 on 01/15/03
  – Cost recovery allowance for 2003:
    30% additional first-year depreciation
    ($10,000 X .30) $ 3,000
    MACRS calculation
    ($10,000-$3,000) x .20  1,400
    Total Cost Recovery $ 4,400
Half-year Convention

- General rule for personalty
- Assets treated as if placed in service (or disposed of) in the middle of taxable year regardless of when actually placed in service (or disposed of)
Example-Half-year Convention

- Bought and placed an asset in service on March 15 (Tax year end is December 31)
  - Treated as placed in service June 30
  - Six months cost recovery in year 1 (and year disposed of, if within recovery period)
Mid-quarter convention

- Applies when more than 40% of personalty was placed in service during last quarter of year
- Assets treated as if placed into service (or disposed of) in the middle of the quarter in which they were actually placed in service (or disposed of)
Example - Mid-Quarter Convention

- Business with 12/31 year end purchased and placed in service the following 5-year class assets (Assume election to not take additional 30% depreciation):
  
  - Asset 1: on 3/28 for $50,000, and
  - Asset 2: on 12/28 for $100,000

- More than 40% placed in service in last quarter; therefore, mid-quarter convention used:
  
  - Asset 1: $50,000 \times 0.20 \times 200\% \times \frac{10.5}{12} = $17,500
  - Asset 2: $100,000 \times 0.20 \times 200\% \times \frac{1.5}{12} = $5,000
### MACRS- Realty (slide 1 of 2)

- **MACRS (after 1986) characteristics:**
  
<table>
<thead>
<tr>
<th>MACRS Realty</th>
<th>Residential Rental</th>
<th>Nonresid. Realty</th>
</tr>
</thead>
<tbody>
<tr>
<td>Statutory lives:</td>
<td>27.5 yrs</td>
<td>31.5 yrs or 39 yrs</td>
</tr>
<tr>
<td>Method:</td>
<td>Straight-line</td>
<td></td>
</tr>
<tr>
<td>Convention:</td>
<td>Mid-month</td>
<td></td>
</tr>
</tbody>
</table>
MACRS-Realty (slide 2 of 2)

• Mid-month Convention
  – Property placed in service at any time during a month is treated as if it were placed in service in the middle of the month
  – Example: Business building placed in service April 25 is treated as placed in service April 15
Optional Straight-line Election

- May elect straight-line rather than accelerated depreciation on personalty placed in service during year
  - Use the class life of the asset for the recovery period
  - Use half-year or mid-quarter convention as applicable
  - Election is made annually by class
Election to Expense Assets
-Section 179 (slide 1 of 5)

- General rules
  - Can elect to immediately expense up to $25,000 (for 2003) of business tangible personalty placed in service during the year
  - Cannot use § 179 for realty or production of income property
Election to Expense Assets
-Section 179 (slide 2 of 5)

• Section 179 general rules
  – Amount expensed reduces depreciable basis
  – Cost recovery available on remaining basis
Annual limitations:
- Expense limitation ($25,000 for 2003) is reduced by amount of § 179 property placed in service during year that exceeds $200,000
- Example: In 2003, taxpayer placed in service $207,000 of § 179 property. The expense limit is reduced to $18,000
  \[\$25,000 - (\$207,000 - \$200,000)\]
Election to Expense Assets
-Section 179 (slide 4 of 5)

• Annual limitations:
  – Election to expense cannot exceed taxable income (before § 179) of taxpayer’s trades or businesses
    • Excess of limitation over taxable income limitation may be carried over to subsequent year(s)
    • Amount carried over still reduces basis currently
Example: Taxpayer buys a $100,000 truck (5-year property) on February 15, 2003 and elects immediate expensing of the maximum amount

Cost of truck $100,000
§ 179 deduction 25,000
30% additional 1st year depreciation

\[\text{[($100,000 - $25,000) \times 0.30]}\]

22,500
Amount subject to ACRS $52,500
MACRS rate .20
Cost recovery allowance $10,500

• Total cost recovery allowed in 2003 is $58,000
($25,000 + $22,500 + $10,500)
**Listed Property** (slide 1 of 4)

- There can be substantial limits on cost recovery of assets considered listed property.
- Listed property includes the following:
  - Passenger automobile
  - Property used for entertainment, recreation, or amusement
  - Computer or peripheral equipment
  - Cellular telephone
Listed Property (slide 2 of 4)

- To be considered as predominantly used for business, business use must exceed 50%.
  - Use of asset for production of income is not considered in this 50% test.
  - If 50% test is met, then both business and production of income use percentages are used to compute cost recovery.
Listed Property (slide 3 of 4)

- To be considered as predominantly used for business (cont’d)
  - If 50% test is met, then allowed to use statutory percentage method of recovery with some limitations
Listed Property  (slide 4 of 4)

• If asset is not used predominantly for business i.e., business use does not exceed 50%  
  – Must use straight-line method 
  – 30% additional first-year depreciation not available 
  – If business use falls to 50% or lower after year property is placed in service, must recapture excess cost recovery
For autos placed in service in 2003, limits are:

<table>
<thead>
<tr>
<th>Year</th>
<th>Recovery Limitation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$3,060</td>
</tr>
<tr>
<td>2</td>
<td>4,900</td>
</tr>
<tr>
<td>3</td>
<td>2,950</td>
</tr>
<tr>
<td></td>
<td>Succeeding years until the cost is recovered</td>
</tr>
</tbody>
</table>
Passenger Auto Cost Recovery Limits (slide 2 of 6)

- Limits are for 100% business use
  - Must reduce limits by percentage of personal use
Limits on Autos and Other Listed Property (slide 3 of 6)

• For passenger automobiles used predominantly in business acquired after 9/10/01 and before 9/11/04, the first year recovery limitation is increased by $4,600
  – First year limit is $7,660 ($3,060 + $4,600)
Example: Taxpayer acquired an auto in 2003 for $30,000 and used it 80% for business.

2003 cost recovery allowance:

\[
\text{($30,000 x 30\%) + [($30,000 - ($30,000 X 30\%)) X .20]} \quad \text{\$13,200}
\]

Deduction is limited to $7,660

\[x \text{ Business use \%} \quad .80\]

Cost recovery allowance $6,128
Passenger Auto Cost Recovery Limits (slide 5 of 6)

- First year limit includes any § 179 expense elected
- Limits apply to passenger autos but not other listed property
  - Cost recovery of passenger auto under straight-line listed property rule still subject to annual limits
Passenger Auto Cost Recovery Limits (slide 6 of 6)

• Leased autos subject to “inclusion amount” rule
  – Using IRS tables, taxpayer has gross income equal to each lease year’s inclusion amount
  – Purpose is to prevent avoidance of cost recovery dollar limits applicable to purchased autos by leasing autos
Alternative Depreciation System (ADS) (slide 1 of 2)

- ADS is an alternative depreciation system that is used in calculating depreciation for:
  - Alternative minimum tax (AMT)
  - Assets used predominantly outside the U.S.
  - Property owned by the taxpayer and leased to tax exempt entities
  - Earnings and profits
Alternative Depreciation System (ADS) (slide 2 of 2)

- Generally, use straight-line recovery without regard to salvage value
  - For AMT, 150% declining balance allowed
  - Half-year, mid-quarter, and mid-month conventions still apply
Amortization

• Can claim amortization deduction on § 197 intangibles
  – Use straight-line recovery over 15 years (180 months) beginning in month intangible is acquired

• Section 197 intangibles include acquired goodwill, going-concern value, trademarks, trade names, copyrights, patents, etc.
Depletion (slide 1 of 4)

- Two methods of natural resource depletion
  - Cost: determined by using the adjusted basis of the resource and allocating over the recoverable units
  - Percentage: determined using percentage provided in Code and multiplying by gross income from resource sales
Depletion (slide 2 of 4)

- Cost depletion
  - Depletion is computed on a per unit basis
  - Per unit amount is determined by dividing the basis of the resource by the estimated recoverable units of resource
    - Number of units sold in year × per unit depletion = depletion for year
  - Total depletion can not exceed total cost of the property
• Percentage depletion
  – Depletion is computed by using the statutory percentage rate for the type of resource
  – Rate is applied to the gross income from the property
Depletion (slide 4 of 4)

- Percentage depletion
  - Percentage depletion cannot exceed 50% of the taxable income (before depletion) from the property
  - Percentage depletion reduces basis in property
  - However, total percentage depletion may exceed the total cost of the property
- Example: Property with zero basis but still generating income
Intangible Drilling Costs (IDC)

• Intangible drilling costs include
  – Costs for making the property ready for drilling
  – Costs of drilling the hole

• Treatment of IDC
  – Expense in the year incurred, or
  – Capitalize and write off through depletion

• It is generally advantageous to write off IDC immediately
If you have any comments or suggestions concerning this PowerPoint Presentation for West's Federal Taxation, please contact:

Dr. Donald R. Trippeer, CPA
donald.trippeer@colostate-pueblo.edu
Colorado State University-Pueblo