Chapter 7

Depreciation, Cost Recovery, Amortization, and Depletion

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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:

	MACRS Personalty	
Statutory lives:	3, 5, 7, 10 yrs	15, 20 yrs
Method:	200% DB	150% DB
Convention:	Half Yr or Mid-Quarter	

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 X .20 X 200% X 10.5/12 = $17,500

  Asset 2: $100,000 X .20 X 200% X 1.5/12 = $5,000

MACRS-Realty (slide 1 of 2)

- MACRS (after 1986) characteristics:

	MACRS Realty	
	Residential Rental	Nonresid. Realty
Statutory lives:	27.5 yrs	31.5 yrs or 39 yrs
Method:	Straight-line	
Convention:	Mid-month	

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

Election to Expense Assets -Section 179 (slide 3 of 5)

- 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

Election to Expense Assets -Section 179 (slide 5 of 5)

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	
[($100,000-$25,000) X .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

Passenger Auto Cost Recovery Limits (slide 1 of 6)

For autos placed in service in 2003, limits are:

Year	Recovery Limitation
1	$3,060
2	4,900
3	2,950
Succeeding years until the cost is recovered	1,775

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)

Limits on Autos and Other Listed Property (slide 4 of 6)

Example: Taxpayer acquired an auto in 2003 for $30,000 and used it 80% for business

2003 cost recovery allowance:	
($30,000 x 30%) + [($30,000-($30,000 X 30%)) X .20]	$13,200
Deduction is limited to $7,660	$7,660
x Business use %	.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 x per unit depletion = depletion for year
  - Total depletion can not exceed total cost of the property

Depletion (slide 3 of 4)

- 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:

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