Depreciable Property

Tab 1 Topics

Related Information

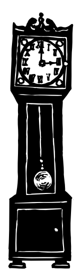
• Depreciating Property Acquired in a Like-Kind Exchange—Tab 9

What Property Can Be Depreciated?

To be depreciable, property must be all of the following:

1) Owned by the taxpayer.
2) Used in a business or investment activity.
3) Have a determinable useful life.
4) Expected to last more than one year.

Observation: The cost of property that doesn't have a determinable useful life generally is capitalized and not recovered until the asset is sold or disposed. On the other hand, the cost of property that has a useful life and is not expected to last more than one year is generally expensed under the taxpayer's normal accounting method (cash or accrual).



Some assets, such as inventory, are not depreciable by definition. Other assets are depreciable in certain situations, but not in others. See the *Quick Chart of Selected Assets—Cases and Rulings* table on Page 1-12 for depreciation rules for many commonly encountered assets.

Owned by the Taxpayer

While property must be owned by the taxpayer to be depreciated, there are situations where the substance of the arrangement, rather than mere legal title, determines ownership for tax.

Interest as a life tenant. When depreciable property is held by one person for life with the remainder interest to another person, the deductions for depreciation are computed as though the life tenant were the absolute owner of the property, even though that person legally only owns an income interest in the property. [IRC §167(d)]

Caution: Depreciation may not be allowed if the remainder interest in the property is held by a related person. See *Property That Cannot Be Depreciated* on Page 1-2.

Observation: After the life tenant's death, the depreciation deductions are claimed by the remainderman (person who receives ownership in the property after the income interest ends) [Reg. §1.167(h)-1(a)]. Depreciation deductions claimed by the life tenant reduce the property's basis both in the hands of the life tenant and in the hands of the remainderman.

Term interests in land and buildings. Taxpayers who purchase a term interest in an asset used in a trade or business (or to produce income) can deduct the cost of that interest over its expected life, even though the property underlying the term interest is not depreciable, as long as the person holding the remainder interest is unrelated.

IRS Ruling: A taxpayer who purchased a 50-year term interest in land, buildings and land improvements was required to allocate the purchase price to the underlying assets. (An unrelated party held the remainder interest in the property.) The amount allocated to buildings and land improvements was depreciated under MACRS as if those assets were owned outright. The amount allocated to the land could be depreciated straight-line over 50 years. (Ltr. Rul. 200852013)

Leased property. An asset may be leased subject to terms that cause the lessee to be treated as the owner for tax. See *Leased Property* on Page 1-3.

Cooperative apartments. Tenant/shareholders can depreciate stock in a cooperative housing corporation (to the extent their apartment is used for business or investment) even though the corporation, not the tenant, owns the building. [IRC §216(c)]

The tenant's deduction is his share of the corporation's depreciation amount.

Co-Op Housing Stock Depreciation Worksheet

1)	Depreciation for all the depreciable real property owned by the corporation in which the taxpayer has a proprietary lease or right of tenancy[1]...............................	1) $__________
2)	*Minus*: Depreciation on space owned by the corporation that can be rented but cannot be lived in by tenant-stockholders	2) <__________>
3)	Depreciation available to shareholders	3) $__________
4)	Tenant's ownership percentage (tenant's number of shares divided by the total number of shares outstanding)..	4) __________%
5)	Tenant's depreciation on his stock (line 3 × line 4)...........	5) $__________

[1] If the co-op stock was bought after its first offering, figure the corporation's depreciation using the following depreciable basis: the tenant's cost per share times the total number of outstanding shares, plus any mortgage debt on the property on the date the stock was purchased and minus any mortgage debt that is not for depreciable real property (for example, debt for the land).

Used in a Business or Income-Producing Activity

To be eligible for depreciation, the property must be used in a business or an investment activity. However, property used in an investment activity is only depreciable if income from the activity is taxable. Personal-use property is not depreciable.

Partial business or investment use. If property used for business or investment purposes also is used for personal purposes, only the business-use or investment-use portion of the asset is depreciable. The taxpayer must keep records showing the business, investment and personal use of the property.

Note: Many assets that can be used for both personal and business/investment purposes are listed property, which is subject to special recordkeeping and depreciation rules. See Tab 6 for more information.

Half-year convention. Under the half-year convention, treat property as placed in service or disposed of on the midpoint of that tax year.

If the short tax year begins on the first day of a month or ends on the last day of a month, the tax year consists of the number of months in the tax year. Treat any part of a month as a full month. Divide the number of months in the short year by two to determine the year's midpoint. Treat property as placed in service or disposed of on either the first day or the midpoint of a month.

Example #1: Tara Corporation, a calendar-year taxpayer, was incorporated on March 15. To apply the half-year convention, Tara has a short tax year of 10 months, ending on December 31. Therefore, the midpoint of the year is five months (10 months ÷ 2) after it begins. During the short tax year, Tara placed property subject to the half-year convention in service. Tara treats this property as placed in service on the first day of the sixth month of the short tax year (August 1).

Example #2: Assume the same facts as in Example #1, except that Tara was incorporated on April 18. The short year will consist of nine months. Therefore, the midpoint of the year is 4.5 months (9 months ÷ 2) after it begins. Tara treats the property as placed in service on the 15th day of the fifth month of the short tax year or August 15.

For a short tax year that (1) does not begin on the first day of a month and (2) does not end on the last day of a month, the tax year consists of the number of days in the year. Determine the year's midpoint by dividing the number of days in the tax year by two.

If the result of dividing the number of days in the tax year by two is not the first day or the midpoint of a month, treat the property as placed in service or disposed of on the nearest preceding first day or midpoint of a month.

Mid-quarter convention. To determine if the mid-quarter convention applies in a short tax year, the basis of property placed in service in the last three months of the tax year is compared to the basis of all property placed in service during the entire tax year, excluding any property not counted for the mid-quarter test (see *Mid-Quarter Convention* on Page 2-5).

Observation: The mid-quarter convention will automatically apply to assets placed in service during a short year consisting of three months or less.

Treat property as placed in service or disposed of on the midpoint of the quarter in which it is placed in service or disposed of under the mid-quarter convention.

For a short tax year of four or eight full calendar months, determine quarters on the basis of whole months. The midpoint of each quarter is either the first day or the midpoint of a month.

For short tax years other than four or eight full months, the midpoint of each quarter is calculated as shown in the next column.

Determining the Midpoint of Each Quarter in a Short Tax Year

Years consisting of anything other than four or eight months

1)	Number of days in the short tax year....................................	1)_____
2)	Number of days in each quarter (line 1 divided by four)........	2)_____
3)	Number of days to midpoint (line 2 divided by two)	3)_____
4)	Starting on the first day of the year, add the number of days in each quarter (line 2) to determine the beginning and ending dates of each quarter. Then, find the midpoint of each quarter. If a midpoint of a quarter is on a day other than the first day or midpoint of a month, treat the property as placed in service or disposed of on the nearest preceding first day or midpoint of that month..	4)_____

Example: Edgar, a calendar-year individual, begins business operations for his proprietorship on March 15 after graduating from college. He places property in service in December. Assume the mid-quarter convention applies to all property Edgar placed in service during the short year. Edgar's short tax year beginning March 15 and ending December 31 consists of 292 days. Each quarter is 73 days (292 days ÷ 4), and the arithmetical midpoint of each quarter is the 37th day.

Quarter	Arithmetical Midpoint	Deemed Placed-in-Service Date
March 15 to May 26..................................	April 20..........................	April 15
May 27 to August 7.....................................	July 2	July 1
August 8 to October 19............................	September 13.............	September 1
October 20 to December 31	November 25.............	November 15

The last quarter of the short tax year begins on October 20, which is 73 days from December 31, the end of the tax year. The 37th day of the last quarter is November 25, which is the midpoint of the quarter. November 25 is not the first day or the midpoint of November, so Edgar must treat the property as placed in service on November 15th (the nearest preceding first day or midpoint of that month).

Computing Depreciation in a Short Tax Year

Pro-rate a full tax year's depreciation when the property is placed in service in a short tax year. The pro-ration is based on the deemed placed in service date under the applicable convention. The numerator of the pro-ration fraction is the number of months (including parts of a month) the property is treated as in service during the tax year (applying the applicable convention), and the denominator is 12.

Example: Mary acquires five-year property for a new proprietorship (she was previously an employee) and places the property in service on June 20 when the business begins. The half-year convention applies to the short tax year beginning on June 20 and ending on December 31, which consists of seven months, and the midpoint of this tax year is mid-September. Therefore, the property is treated as being placed in service on September 15. Short tax year depreciation is calculated by multiplying the property's tax basis by 40% (double declining balance rate for five-year property) and by 3½ ÷ 12 (number of months property was in service divided by number of months in a full year).

Caution: The optional MACRS depreciation tables cannot be used to compute depreciation in a short year.

Section 179 Deduction for a Short Tax Year

If a Section 179 deduction is elected for property placed in service in a short tax year, no pro-ration of the Section 179 expense is required. [Reg. §1.179-1(c)]

Computing Depreciation After a Short Year

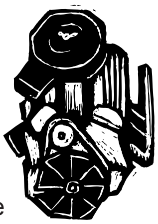
For the tax years after the first short year, depreciation may be computed using either the simplified method or the allocation method (Rev. Proc. 89-15). The method chosen must be consistently used until the tax year that a switch to the MACRS straight-line (SL) method is required because it produces a larger depreciation deduction. Usually, both methods produce the same depreciation allowance.

Simplified method. Calculate depreciation for a later 12-month year in the recovery period by multiplying the adjusted basis of the property at the beginning of the year by the applicable depreciation rate.

Standard Mileage Rates vs. Actual Costs

See *Comparison of Standard Mileage Rate and Actual Cost Methods (2012)* below for an overview of the methods.

Standard Mileage Rate Method



Owned vehicles. Taxpayers must elect to use the standard mileage method in the year the car is placed in service for business purposes. In later years, taxpayers can switch to the actual expense method. But if a switch to the actual expense method occurs, the straight-line method must be used to depreciate the vehicle based on its remaining useful life. The basis must be reduced by the depreciation assumed while using the standard mileage method.

Note: Starting in 2011, the standard mileage rate is available for autos used for hire, such as taxicabs. (Rev. Proc. 2010-51)

Adjustment to basis. For 2012, 23¢ is the deemed depreciation rate for each mile claimed under the standard mileage rate. (Notice 2012-1)

Note: The vehicle's basis cannot be reduced below zero. When the basis of a vehicle is depreciated to zero, deductions continue at the standard rate per mile for the year, but no additional basis adjustments are made.

Example: Bob used the standard mileage rate method to report expenses from his used car purchased on August 2, 2011, for $18,000. He drove 9,000 and 20,000 business miles during 2011 and 2012, which represented 80% business use. On December 24, 2012, Bob sells the car.

Bob's adjusted basis for a sale or trade:

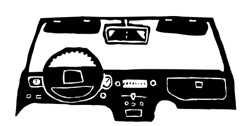
	Total	80% Business	20% Personal
Original cost or basis	$ 18,000	$ 14,400	$ 3,600
Less: Depreciation component of standard mileage rate:			
2011 (9,000 × 22¢ per mile)	< 1,980 >	< 1,980 >	0
2012 (20,000 × 23¢ per mile)	< 4,600 >	< 4,600 >	0
Adjusted basis of car	$ 11,420	$ 7,820	$ 3,600

Bob's gain or loss on the sale of the car for $12,500:

	Total	80% Business	20% Personal
Sales proceeds	$ 12,500	$ 10,000	$ 2,500
Adjusted basis	< 11,420 >	< 7,820 >	< 3,600 >
Gain (loss) on sale	$ 1,080	$ 2,180	< 1,100 >

The $2,180 gain on the business portion is a taxable Section 1231 gain (subject to Section 1245 recapture) and is reported on Form 4797. The $1,100 loss on the personal portion is a nondeductible personal loss and is not reported on Bob's return. If a gain had been realized on the personal portion, it would have been reported as long-term capital gain on Schedule D.

Comparison of Standard Mileage Rate and Actual Cost Methods (2012)[1]

	Standard Mileage Rate Method	Actual Cost Method
Available to	• Self-employed individuals and employees using a car for business (including a rental activity) (business mileage rate). • Individuals using a car for charitable, medical or job-related moving purposes (charitable, medical or job-related move rates). *Exceptions:* Not available to taxpayers who: • Use five or more cars simultaneously in their business. • Claimed depreciation using a method other than SL, a Section 179 deduction or special depreciation allowance for the car. • Previously claimed actual car expense for a car they lease. • Are using an employer-provided vehicle for business. • Are rural mail carriers and receive a qualified reimbursement.	Any taxpayer using a car for business, investment, charitable, medical or job-related moving purposes. Taxpayers can convert from the standard mileage method to the actual cost method any year for vehicles they own. If the vehicle is not fully depreciated, the taxpayer must use SL depreciation based on remaining useful life. 
Calculating the deduction	Multiply the following rates per mile by the number of miles driven: • Business—55.5¢ per mile. • Charitable—14¢ per mile. • Medical—23¢ per mile. • Job-related move—23¢ per mile. No additional deductions are allowed for the actual costs of owning and operating the car [such as depreciation or lease payments, maintenance, repairs, tires, gasoline (including gasoline taxes), oil, insurance and registration fees].	Determine percentage of use (based on miles driven) for business, charitable, medical or moving purposes. Apply that percentage to actual expenses of owning and operating the vehicle, including: gasoline and oil, tires, lease payments, maintenance and repairs, insurance, registration fees and licenses and basis for depreciation/ Section 179 expensing. *Exception:* For charitable, medical or moving use may deduct actual out-of-pocket costs directly attributable to use. No portion of depreciation, Section 179, insurance or general maintenance expenses can be deducted.
Additional deductible expenses	• Parking fees and tolls for business, charitable, medical or moving use. • Business percentage of interest and personal property taxes. (**Caution:** Employees must treat all interest as personal interest.) • Nonbusiness percentage of personal property taxes (Schedule A itemized deduction).	
Depreciation and Section 179 rules	• Basis reduced (but not below zero) by 12¢ per business mile for 1994–1999, 14¢ per mile for 2000, 15¢ per mile for 2001–2002, 16¢ per mile for 2003–2004, 17¢ per mile for 2005–2006, 19¢ per mile for 2007, 21¢ per mile for 2008–2009, 23¢ per mile for 2010, 22¢ per mile for 2011 and 23¢ per mile for 2012. • No Section 179 expense or special depreciation allowance available.	• Generally, 200% DB five-year recovery period. But, can elect SL over five years (ADS) or 150% DB over five years (AMT method). See Tab 4 for MACRS depreciation tables. • Annual depreciation and Section 179 deduction limited under Section 280F for passenger autos. • If used 50% or less for business, must use SL/five-year recovery period. No Section 179 or special depreciation allowance available.

[1] These methods are available for cars, which includes a van, pickup or panel truck.

Note: See Rev. Proc. 2010-51 for detailed definitions and discussion of using standard mileage rates.