Chapter 6
Property acquisitions and cost recovery deductions

Key Concepts

- Basis is a taxpayer's unrecovered investment in an asset. Taxpayers can recover their basis in an asset without tax cost; any excess recovered beyond basis results in realized gain that may be subject to taxation.
- Depreciation, depletion, and amortization are ways an asset's cost is recovered. Adjusted basis is basis that is reduced for cost recovery deductions.
- Annual cost recovery deductions provide tax savings and reduce the effective after-tax cost of an asset. The shorter an asset's recovery period, the lower the after-tax cost.
- Section 179 allows immediate expensing of up to $102,000 of qualified personalty. The expensed amount reduces an asset's basis; the remaining basis is depreciated using regular MACRS depreciation.
- Qualifying new personalty is eligible for an additional 50 percent depreciation in the year of acquisition; this provision is considered after the Section 179 expense deduction, and both are applied before regular MACRS depreciation is calculated.
- The cost of natural resources is recovered through depletion. For certain natural resources, taxpayers annually can elect the greater of cost depletion or percentage depletion.
- The cost of intangible assets acquired in the purchase of a business is recovered using the straight-line method over 15 years.

1. Capital expenditures

Deducted currently
Capitalized until disposal
Capitalized with MACRS applied

2. Basis of property

   a. General

   Basis is the unrecovered investment in an asset that can be recovered without tax cost.

   Original basis of an asset includes:
   Cash and FMV of property given up by purchaser
   Money borrowed and used to pay for the property
   Liabilities of the seller assumed or taken "subject to" by the purchaser
   Expenses of making the purchase

   If more than one asset is acquired in a single transaction, cost is apportioned by relative FMV method. Instead, buyer and seller can agree to a written allocation of the purchase price to individual assets.

Nondeductible capital expenditures that prolong its useful life or enhance its usefulness increase the asset's basis. Depreciation reduces the asset's basis. Casualty losses reduce the asset's basis.

MACRS is allowed on property that is used in a T/B or income-producing property.

If property is converted from pleasure to business use, the basis for depreciation is the lesser of the property's adjusted basis or FMV at time of conversion.

If a TP fails to claim depreciation on an asset in any year, the basis of the asset is still reduced by the allowable depreciation the TP should have claimed. TP may not claim a bigger deduction in a later year, but may file an amended tax return for the year in question.

b. Acquisition in a taxable exchange for services or property rather than cash. Basis is FMV of property or services.

c. Acquisition by gift
Donee takes the donor's adjusted basis in appreciated property as her basis.

Donee increases the donor's adjusted basis by the amount of gift tax attributable to the net increase in value of the gift property up to the date of the gift.

$$\text{Gift tax paid by donor} \times \frac{\text{FMV at date of gift} - \text{donor's adjusted basis}}{\text{FMV at date of gift}}$$

If FMV on date of the gift is less than the donor's basis and the gift property is sold at a loss, donee uses the FMV as basis.

If FMV on date of the gift is less than the donor's basis and the gift property is sold for more than FMV but less than the donor's basis, donee has neither gain nor loss.

d. Acquisition by inheritance
Beneficiaries use FMV for their basis in inherited property.

3. Cost recovery systems
   a. General
   Realty includes land and buildings
   Personalty is all the rest

Study Table 6.1 MACRS recovery periods and averaging conventions

b. Averaging conventions. All the IRS depreciation tables incorporate the appropriate averaging conventions.

Half-year averaging convention (Table 6.2)

Mid-quarter convention (Table 6.3)

Mid-month convention for realty (not land) (Tables 6.4 and 6.5)

c. Mixed-use assets (business and personal pleasure)
Depreciation is permitted for business or investment-use only.

d. Year of disposition
Must use the same averaging convention in the year of sale or disposition that applied at acquisition.

e. Alternative depreciation system (ADS)
ADS is computed using the straight-line method and applying the appropriate averaging convention.
Study Table 6.6 ADS Straight-line

ADS must be used for the following:
Certain listed property
In computing earnings and profits
For property financed with tax-exempt bonds
For property used outside the US
For property used by a tax-exempt entity
To compute the portion of depreciation treated as an AMT adjustment

f. Section 179 election to expense personalty (New or used)
To benefit small businesses, Section 179 allows a TP to elect to write-off up to $102,000 of the acquisition cost of tangible business property.

NOT ALLOWED ON REALTY
NOT ALLOWED ON INVESTMENT ACTIVITY ASSETS
NOT ALLOWED ON PROPERTY ACQUIRED BY GIFT, INHERITANCE, OR FROM A RELATED PARTY

179 election reduces the basis the same as any other type of depreciation.
Election is made on an annual basis.
Election applies to the acquisition cost of property placed in service during the year.
Any excess cost over the amount expensed is subject to regular MACRS depreciation.
If TP acquires over $410,000 of qualifying personalty during the year, any excess over $410,000 reduces the maximum annual limitation on a dollar-for-dollar basis.

The amount expensed is limited to the taxable income from the TP's business, determined before the 179 deduction. If this limit applies, the currently nondeductible portion may be carried to future tax years, subject to the applicable maximum each year.

A TP may choose to use all, part, or none of the 179 election.

The $102,000 annual limit applies separately to each business entity (C corporation, S corporation, and partnership) and to individual TPs.

Amounts expensed under 179 are not counted for the test in determining if more than 40% of assets are placed in service in the last quarter of the year.

g. Additional first-year bonus depreciation (**Only new property**)

Taxpayers who purchased qualified new assets before May 6, 2003 were eligible for an additional 30% first-year bonus depreciation. Taxpayers who purchase qualified new assets after May 5, 2003 and before January 1, 2005 are eligible for 50% first-year bonus depreciation.

Section 179 expensing can be combined with the 50% additional first-year bonus depreciation; regular depreciation can then be claimed on any remaining basis. The additional first-year depreciation continues to apply only to new property while Section 179 expensing may be claimed on new or used property.

The full 50% may be claimed even if the mid-quarter convention must be used.

Let’s look at Table 6.7

PROVISIONS LIMITING DEPRECIATION

Mixed-use assets
If an asset is used for both business and personal purposes, depreciation is permitted for the business-use or investment-use portion only.

Limited MACRS for listed property (used for business and pleasure)
Passenger automobiles
Computers
Cellular phones
Entertainment, amusement, recreation property

To be excluded, the listed property must be owned or leased by the business and used exclusively at the business.

TP must substantiate the % of time an asset is used for business.
If the property is used more than 50% for business, can use MACRS, 179 election, and bonus.

If 50% or less, must use ADS straight-line and get no 179 election or bonus.
Investment purposes does not constitute business for 50% test

Once have to use ADS, must continue to do so even if business use subsequently exceeds 50%.

If business use decreases to 50% or less, a portion of the depreciation claimed under MACRS for business use of listed property must be recaptured as ordinary income. The amount that must be recaptured is the excess of depreciation deducted (including bonus and 179) and the alternative straight-line depreciation.

Employee owned property that is used for business cannot be depreciated unless:
Use of property must be for the convenience of the employer and
Use of property must be required as a condition of employment.
Is the employee relieving the employer from providing an asset that is required to perform the job?

Passenger Vehicles (6000 pounds)

New automobiles acquired before May 6, 2003 have first-year depreciation ceiling limits of $7,660 when the additional 30% first year depreciation is claimed ($3,060 base amount + $4,600 additional 30%). New automobiles acquired after May 5, 2003 have an increased first-year depreciation ceiling of limit of $10,710 ($3,060 base amount + $7,650 additional 50%) when the additional 50% first-year depreciation is claimed. The ceiling for used automobiles remains at $3,060. The following table provides the revised depreciation ceiling limitations for new automobiles acquired in 2003.

Revised Depreciation Ceiling Limits for Automobiles

	Basic	Additional 30%	Additional 50%	Maximum
Year 1 (if acquired before May 6, 2003)	$3,060	$4,600		$7,660
Year 1 (if acquired after May 5, 2003)	3,060		$7,650	10,710
Year 2	4,900			4,900
Year 3	2,950			2,950
Year 4 and later	1,775			1,775

As under previous law, the automobile ceiling limits do not apply to vehicles weighing more than 6,000 pounds. With the new $102,000 expensing limit under Section 179, this means that very heavy SUVs and other vehicles weighing more than 6,000 that cost less than $102,000 could be expensed in full in the first year.

h. Auto leasing

Taxpayers who lease autos can deduct the business portion of their lease payments.

To prevent TPs from taking advantage of the difference between lease payments and the limit on depreciation deductions on luxury automobiles, TPs must add a lease inclusion amount to their income.

The inclusion is based on the FMV of the auto and is prorated for the number of days the auto is leased.

This lease inclusion factor replaces the depreciation ceiling limits that apply to car buyers.

Table 6.10 IRS Table for lease inclusion amounts

4. Depletion used for recovering the cost of natural resources

Cost depletion

% Depletion

5. Amortization used for recovering the cost of intangible assets

Intangibles with a perpetual life that cannot be amortized (stock and other equity interests)

15-year intangibles acquired as part of a business purchase (section 197 assets)
Goodwill

Intangibles amortizable over a life other than 15 years
Sports franchises, patents, and copyrights not acquired as part of a purchase are amortized over the expected legal life.
Patents use 17 years
Copyrights retained for 50 years after the author’s death
Customer list can be amortized if a definite and limited life can be established.

Research and experimentation
Expense in full in year incurred or paid
Amortize them over a period of not less than 60 months
Capitalize them