Chapter 10 Notes

Property Acquisition and Cost Recovery

This entire chapter is from the point of view of the business. Everything here is a business deduction and we are dealing with assets with a useful life of more than one year.

**Basis** – effectively means your investment in an asset

An asset’ cost basis includes all expenses to purchase, prepare the asset for use, and begin using the asset.

Why is basis important?

Basis is an important number in the tax world. It tells you whether you have a gain or loss and how large it is. You can’t determine how much tax you owe, if any, without knowing your basis in the asset.

Cost Basis Calculation:

Purchase price of the asset

Plus: Additional expenses incurred in the purchase of the asset (e.g., sales tax, legal fees, etc.)

Plus: Additional expenses necessary to prepare that asset and begin use (e.g., shipping, installation, modifications, etc.) (e.g.,: clearing land to build a building – costs are capitalized and added to the basis of the asset)

Equals: Basis (the initial basis is the cost plus all expenses to purchase, prepare the asset for use, and begin use of the asset)

Basis – Accumulated depreciation (amortization or depletion) = Adjusted Basis or tax basis (amount of the asset’s cost that is yet to be recovered)

Adjusted basis can never go below zero. Once the basis of the asset is established, the basis is reduced as the business recovers the cost of the asset through cost recovery deductions (i.e., depreciation, amortization, and depletion).

What if multiple assets are purchased at the same time?

TP must determine a cost basis for each asset. Example: purchase a building (because a building is attached to land); cost or value of the land and building is typically included in the contract or the business may use an appraisal to determine the cost basis of the land and building separately.

How do taxpayers know if they should immediately deduct the cost of an asset or capitalize and depreciate it?

De minimis safe harbor provision – taxpayers can immediately deduct amounts paid for tangible personal property up to $5,000 (if business has AFS) or $2,500 (if business does not have AFS).

How do asset-related expenses affect an asset’s basis? It depends on the purpose of the expense.

- Routine maintenance: expense in the current period (ex: oil change, building cleaning services)

- Costs that significantly extend the useful life of the asset or increase the value of the asset: capitalize and treat as a new asset (ex: costs to replace a roof of a bldg.; adding a wing to an office bldg.)

**Example 1**: Scrap-Happy Inc., a scrapbooking retail chain, purchased an old office building for $175,000 for use in expanding its current operations. An additional $15,000 was spent painting and remodeling the building in preparation for its opening. Two years later, a Scrap-Happy employee discovered that several leaks in the roof were causing serous water damage to the store’s inventory; the company spent $50,000 to re-roof the building. Every six months, Scrap-Happy pays $500 to have the carpet professionally cleaned. What is the original basis of the building? What effects do the last two transactions have on the original basis of the building?

a) original basis: $175,000 (initial cost) + $15,000 (painting and remodeling) = $190,000

b) $50,000 re-roofing expense: added to the basis (restoration of a major component of the building)

$500 bi-annual carpet cleaning: no effect on basis (routine maintenance – expense immediately)

**Cost Recovery** – depreciation, amortization, and depletion

We want to recover the cost of assets asap. There are conceptual differences between depreciation for financial accounting and tax. Financial accounting reflects the actual use, while tax recovers the cost over a shorter period.

The type of cost recovery used (depreciation, amortization, or depletion) depends on the underlying asset.

Depreciation is a method of deducting the cost of tangible real or personal property over a period of time.

Amortization is a method of deducting the cost of intangible assets over a period of time.

Depletion is a method of deducting the cost of natural resources over time (e.g., oil).

Cost recovery deductions are allowed if:

1. Capital asset used in a trade or business, or held for the production of income

Capital asset means an asset with a useful life of more than one year.

2. Determinable useful life

You cannot depreciate land because you have no idea how long the land will be useful.

You cannot depreciate stock because you have no idea how long the company will be around.

You recover your basis for these types of assets on the day of the sale.

Major types of assets for cost recovery:

1. Tangible assets (real or personal property) – depreciate

Real property: land or anything permanently attached to the land (i.e., buildings).

Personal property: anything that is not real property (e.g., a machinery and equipment, computers, furniture). Personal property is not property for personal use, it is property used in a business.

2. Intangible assets (e.g., goodwill, patents, etc.) – amortize

Other examples are covenants not-to-compete and copyrights.

3. Natural resources (e.g. oil, gold, etc.) – deplete

We won’t focus on depletion because the rules are very complicated.

**Depreciation**

Depreciation rules change a lot. Depreciation is one of the primary tools that the government uses to stimulate the economy. The government wants to incentivize businesses to spend money to purchase depreciable assets because it helps the economy – so tax rules for depreciation are generally favourable.

The following information is necessary to calculate depreciation:

1. Depreciable basis = original basis – Section 179 expense

Section 179 allows a taxpayer to immediately deduct a portion of the cost of the asset.

2. Depreciation method – assume MACRS for the purposes of this class (MACRS = Modified Accelerated Cost Recovery System)

3. Recovery period (depreciable life of the asset)

Also known as the useful life; Rev. Proc. 87-56 describes the useful life.

4. Convention – half-year or mid-quarter (personal property) or mid-month (real property)

a. Affects the first year of depreciation and the year of disposition.

A convention is an assumption about when the asset is placed into service – must use the asset to recover the cost (you can’t just buy it and take depreciation deductions – the asset must be placed in service before depreciation can be taken on it).

The method, recovery, period, and convention are based on whether the asset is real or personal property.

MACRS Depreciation Methods (corresponds to #2 above)

1. 200% (double) declining balance (default method)

2. 150% declining balance

3. Straight-line

Not covering either 2 or 3.

Deprecation Recovery Period (corresponds to #3 above) – for financial accounting purposes, an asset’s depreciable life is determined by the taxpayer – for tax purposes, an asset’s depreciable life is predetermined by the IRS in Rev. Proc. 87-56.

- Provided in Revenue Procedure 87-56 (applies whether an asset new or acquired used)

1. Personal property – examples:

Office furniture and equipment – 7 years

Cars and light-duty trucks – 5 years

Manufacturing equipment – 7 years

Computing equipment – 5 years

Computer software – 3 years

2. Real property

Residential real property – 27.5 years

Nonresidential property placed into service on or after May 13, 1993 – 39 years

Nonresidential property placed into service before May 13, 1993 – 31.5 years

I will tell you what the useful life of the asset is for a quiz or exam.

Correctly classifying assets may save a client a lot of money, but the client must maintain receipts for the asset purchase.

Conventions (corresponds to #4 above)

An assumption about when an asset is placed into service. You do not get to choose your convention; the IRS tells you what to use (Rev. Proc. 87-56).

The depreciation conventions specifies the portion of the full year’s depreciation that the business can deduct for an asset in the year the asset was first placed into service and the year the asset is sold.

Half-year convention applies most of the time, but in certain cases, the taxpayers will have to use the mid-quarter convention.

*Personal Property*

1. Half-Year Convention (DDB - default convention; always start here)

Assumes that the asset was placed into service on July 1st – no matter when it is actually placed in service.

a. Year placed into service: ½ year of depreciation (already included in depreciation table), regardless of when the asset was placed into service

b. Year of disposition: ½ year of depreciation (must calculate if sold before end of recovery period because the tables assume that the asset is held for the full year)

See exam reference page for cost recovery tables.

All categories have one more year than the useful life because you only get a ½ year of depreciation in the first year.

Annual depreciation expense = depreciable basis (*full* basis, not yet adjusted) \* cost recovery percentage from IRS table

The MACRS tables are for double-declining balance. For example, take the 7-year property.

1/7 (2) = .2875 (1/2) = 0.1429 (first number under 7 year in the half-year convention table)

Multiply by 2 for double-declining balance (twice straight-line); multiply by ½ for the half-year convention (only get a half-year’s depreciation the first year).

1-0.1429 = 0.8571\*(.2875) = 0.2449 (the second number in the 7-year column of the table)

Moral of the story: the table does everything for you.

**Example 2a**: Proctor and Gamble purchases equipment (7-year property) with a depreciable basis of $500,000 and placed the asset in service on July 20, 2016. This was the only purchase of equipment for the year. What is the maximum cost recovery deduction Proctor and Gamble can claim for the purchase in 2016, 2017, and 2018? What is the accumulated depreciation on the asset through 2018? Ignore Section 179 and bonus depreciation.

2016: depreciable basis = $500,000

Cost recovery deduction:

2016: 500,000\*.1429 = $71,450

2017: 500,000\*.2449 = 122,450

2018: 500,000\*.1749 = 87,450

Total accumulated depreciation through 2018 on this equipment: $281,350

**Example 2b**: Assume Proctor and Gamble (P&G) sells the equipment on February 20, 2019. What is the cost recovery deduction that year, if any? What is the cost recovery if P&G sells the equipment on January 5, 2023? What is the cost recovery deduction, if any, if P&G sells the equipment on December 31, 2016?

**2019**: 500,000\*.1249 = $62,450(1/2) = $31,225

In the year of the sale, you only get a half-year’s depreciation.

**2023**: 500,000\*.0446 = $22,300

The last percentage already reflects the HY convention.

**2016**: no depreciation expense allowed because asset placed in service and sold in the same year.

2. Mid-Quarter Convention – similar to HY convention

If you meet these criteria, you must use this convention. Only look at personal property placed into service during the year to determine whether you must use this convention.

Treats assets as if they were placed into service during the middle of the quarter in which the business actually placed the asset into service.

a. Apply mid-quarter convention to ***all*** tangible personal property assets purchased during the year when more than 40% of the depreciable basis of tangible *personal* property is placed into service in the last three months of the year (i.e., the 4th quarter). (All pieces of *personal* property placed in service during the year – if more that 40% threshold is not met, use HY convention)

b. Year placed into service: ½ quarter of depreciation plus all subsequent quarters of depreciation (already included in the depreciation table)

c. Year of disposition: ½ quarter of depreciation in the quarter of sale plus all preceding quarters of depreciation (must calculate if sold before the end of the recovery period)

|  |  |  |
| --- | --- | --- |
| **Quarter of Disposition** | **Percentage** | **Calculation** |
| First | 12.5 | 1.5/12 |
| Second | 37.5 | 4.5/12 |
| Third | 62.5 | 7.5/12 |
| Fourth | 87.5 | 10.5/12 |

- or calculate this way: Depreciation expense = full year of depreciation \* [(quarter in which the assets is disposed of – 0.5)/4] 🡨 this is the fraction of the full year’s depreciation the business is allowed to take,

where the quarter of asset disposal = 1, 2, 3, or 4; subtract .5 because treated as though the asset was disposed in the middle of the quarter.

**Example 3a**: Computing Services purchased computers (5-year property) with a depreciable basis of $400,000 on May 5, 2018 (Q2). In addition, Computing Services purchases office furniture (7-year property) with a depreciable basis of $600,000 on November 12, 2018 (Q4). What is Computing Services cost recovery deduction in 2018 and 2019? Ignore Section 179 and Bonus depreciation.

1) Determine if mid-quarter convention applies (only look at personal property here, real property is not included in the ratio):

600,000/1,000,000 = 60% so yes, mid-quarter convention applies

|  |  |
| --- | --- |
| Computer: | Office Furniture: |
| 2018: $400,000\*.25 = 100,000 | 2018: 600,000\*.0357 = 21,420 |
| 2019: 400,000\*.3 = 120,000 | 2019: 600,000\*.2755 = 165,300 |
| 5-year property, 2nd quarter, recovery years 1 and 2 | 7-year property, 4th quarter, recovery years 1 and 2 |

**Example 3b**: Assume further that Computing Services also placed a building in service on July 1, 2018 costing $1,000,000. Is Computing Services subject to the Mid-Quarter Convention?

Yes. Because the building is real property (not personal property), it is not included in the MQ calculation.

**Example 3c**: Assume that Computing Services sells the computers on September 23, 2019. What is the depreciation deduction for 2019, if any?

2019: 400,000\*.30 = $120,000\*62.5% = $75,000 (depreciation deduction in 2019, the year of sale)

-multiply the amount of depreciation the business would have been able to claim on the asset if it had not sold the asset (full year depreciation) by the applicable disposition percentage.

3 in (3-.5) because September is in the 3rd quarter of the year.

*Real Property*

Land and anything attached (e.g., office bldg., manufacturing plant, warehouse - don’t depreciate land) – only one convention

Residential real property has a 27.5-year recovery period. Nonresidential real property has a 39-year recovery period.

Mid-Month Convention (straight-line method) – always used for real property (like the MQ, but in months instead)

a. Year placed into service: ½ month of depreciation in month of acquisition plus all subsequent months of depreciation (already included in depreciation table)

b. Year of disposition: ½ month of depreciation in the month of disposition plus all preceding months of depreciation (must calculate if sold before end of recovery period)

-Depreciation expense in disposition year = full year of depreciation \* [(month in which the asset is disposed of - .5)/12]

Subtract .5 because treated as though the asset was disposed in the middle of the month.

**Example 4a**: Dow Chemical purchased a new plant for $4,000,000 on May 15, 2018. $1,500,000 of the purchase price is allocated to the land the plant is built on while the remainder of the purchase price is allocated to the plant. What is Dow Chemical’s depreciation deduction in 2018?

Steps:

1) determine the type of property (on the MACRS table) – 39 years – nonresidential property

2) determine the month property is placed in service – 5th month

3) determine cost recovery % for the correct year – year 1

Depreciable basis: $2,500,000\*0.01605 = $40,125

(month 5, year 1, non-residential real property)

**Example 4b**: Assume Dow Chemical added a wing to the plant costing $900,000. How is the addition treated for tax purposes?

The addition of the wing to the plant is a substantial improvement – addition is treated as a new asset with same recovery period of the original plant, i.e., non-residential real property depreciable over 39 years.

**Example 4c**: Assume that Dow Chemical sells the plant on April 12, 2024. What is Dow Chemical’s depreciation deduction in 2023?

2024: $2,500,000\*0.02564 = $64,100 \* [(4-.5)/12)] = $18,695.83

Full month of depreciation for Jan, Feb, and March and a ½ month of depreciation in April – calculate full year depreciation expense as if the asset was held for the entire year 🡪 still use month 5 row on table.

**Special Depreciation Provisions for Personal Property**

*Section 179 Expensing*

This provision allows for immediate cost recovery in addition to depreciation.

1. Applies to tangible personal property **only**

2. Applies regardless of whether property is purchased new or used (as long as new to you)

3. Allowed **only in the first year** the property is placed into service

4. Allows for the immediate expensing of up to $1,000,000 of property (amount applicable for year 2018).

The $1,000,000 amount applies across all items of property placed into service that year, not per asset.

5. Section 179 expense reduces depreciable basis AND is applied before determining the appropriate convention (i.e., half-year or mid-quarter) and computing MACRS depreciation expense.

6. Can choose which (tangible personal property) assets to expense immediately under Section 179

a. General rule: Allocate Section 179 expense to the asset(s) with lowest first-year cost recovery percentage.

Limits on Section 179 Expense:

1. Asset must be purchased from an unrelated party – trying to prevent income shifting

2. Maximum amount of Section 179 expense is reduced dollar for dollar when the amount of tangible personal property placed into service in 2018 exceeds $2,500,000 (phase-out limitation)

Do not include real property in this calculation. The phased-out portion of the deduction disappears and does not carry over to another year.

3. Deductible 179 expense cannot exceed taxable income (including depreciation, but not 179 expense) from the conduct of a trade or business. If the limit applies, the excess is carried over and is deductible in the following year, subject to the taxable income limitation.

This prevents you from creating or extending a net operating loss due to Section 179 expensing.

4. $1,000,000 maximum applies to all entities, over all purchases of tangible personal property.

So, if a taxpayer has multiple businesses and acquires assets across all of the businesses, when the taxpayer files her return, the TP may only deduct to the $1,000,000 maximum amount for the combined businesses. If there is excess Section 179 due to the taxable income limitation, the excess carries forward to subsequent years.

Steps for Problems with §179

1. Determine the convention (i.e., HY, MQ) before applying the §179 expense.

2. Apply the §179 expense to the asset with the lowest first-year cost recovery percentage.

3. Determine the convention again after applying the §179 expense.

4. Apply remaining §179 expense, if any, to the asset with the lowest first-year cost recovery percentage.

5. Repeat steps (3) and (4) as necessary.

**Example 5a**: MaroonOut, Inc. purchased assets with a 5-year useful life worth $2,645,000 in 2018. What is the maximum Section 179 expense for MaroonOut in 2018?

2,645,000 – 2,500,000 = 145,000 reduction in Section 179 expense

Deduct: 1,000,000 – 145,000 = 855,000 (Section 179 expense in 2018)

**Example 5b**: Using the same facts as above, assume MaroonOut has taxable income (after regular depreciation) of $275,000. What is the maximum Section 179 expense for MaroonOut in 2018? What happens to the excess, if any?

Maximum Section 179 expense in 2018 is $275,000 because of the taxable income limitation --- cannot cause a net operating tax loss. The excess ($580,000) is carried over indefinitely to the future subject to the taxable income limitation.

**Example 6**: Texas Instruments purchased $1,315,000 of computers (5-year property) on June 1, 2018. What is the maximum cost recovery deduction Texas Instruments can take for the computers in 2018? If necessary, assume Texas Instruments has sufficient taxable income to deduct the full amount of allowed Section 179 expense and that the computers were the only items purchased during the year. Ignore bonus depreciation.

1,315,000

(1,000,000) Section 179 expense

$315,000 Depreciable basis

x 0.20 (half-year convention – purchased before last quarter, 5-year property)

$63,000 Depreciation expense

Maximum cost recovery = $1,000,000 + 63,000 = $1,063,000

**Example 7**: Mosaic Designers, Inc. purchased two assets in 2018. The company purchased computing equipment (5-year property) for $1,115,000 on December 15, 2018 and office furniture (7-year property) for $400,000 on November 10, 2018. What is the maximum cost recovery deduction for these assets (ignore bonus depreciation) in 2018?

Steps for working these problems:

1. Determine the convention before applying the section 179 expense.

100% purchased during the fourth quarter so mid-quarter convention applies.

2. Apply the Section 179 expense to the asset with the lowest first-year cost recovery percentage.

Furniture – 3.57%; computing equipment – 5%, so choose furniture

3. Determine the convention after applying the section 179 expense.

Still 100% in fourth quarter, so mid-quarter convention

4. Apply remaining section 179 expense, if any, to the asset with the lowest first-year cost recovery percentage.

None left in this instance

5. Repeat steps (3) and (4) as necessary.

1. 1,515,000/1,515,000 = 100% (mid-quarter)

2. 400,000

(400,000) Section 179 expense

0 depreciable basis

3. 1,115,000/1,115,000 = 100% (mid-quarter)

4. 1,115,000

(600,000) Remaining Section 179 expense

515,000 Depreciable basis

Depreciation: $515,000\*.05 = $25,750

Maximum cost recovery: 1,000,000 + 25,750 = $1,025,750

**Example 8**: RST, Inc. purchased three assets in 2018. The company purchased office furniture (7-year property) for $250,000 on May 14, 2018, computing equipment (5-year property) for $175,000 on August 12, 2018, and machinery (7-year property) for $915,000 on December 15, 2018. What is the maximum cost recovery deduction for these assets (ignore bonus depreciation) in 2018?

1. 915,000/1,340,000 = 68% (mid-quarter convention applies)

2. furniture – 17.85%, computing equipment – 15%, machinery – 3.57%, so allocate Section 179 to the machinery first

915,000

(915,000) Section 179 expense

0 Depreciable basis

3. 0/425,000 = 0% (half-year convention applies)

4. furniture – 14.29%, computing equipment – 20%, so allocate the remaining $85,000 of Section 179 expense to the furniture.

250,000

(85,000) Section 179 expense

165,000 Depreciable basis

Depreciation: furniture – 165,000\*.1429 = $23,578.50

Computing equipment – 175,000\*.2 = $35,000

Maximum cost recovery deduction: 1,000,000 + 23,578.50 + 35,000 = $1,058,578.50

*Bonus Depreciation*

Allows taxpayers to immediately expense 100% of qualified property.

* recovery period of 20 years or less
* original use must commence with taxpayer
* placed in service after September 27, 2017 (TCJA)
* calculate after Section 179 but before MACRS
* taxpayers may elect not to take

**Amortization**

Businesses recover the costs of intangible assets through amortization rather than depreciation expense. An intangible asset can be placed into one of four categories: Section 197 purchased intangibles, start-up expenditures, research and experimentation costs, patents and copyrights.

*Section 197 Intangibles*

1. Occurs when a business acquires another business for a single purchase price

2. Intangible assets such as customer lists, patents, trademarks, goodwill (ex: company’s reputation), going concern value, covenants not to compete (have the people whose business they buy promise not to practice in that area for a certain number of years), etc. – the value of these assets is determined after allocating a portion of the purchase price to the tangible assets equal to their FMV on the date of purchase.

3. Amortized over 180 months (15 years) regardless of its useful life

4. Use full-month convention (receive full month of amortization regardless of what day the other business was purchased or sold)

*Organizational Expenditures and Start-up Costs*

Organizational expenses – expenditures to form or organize a business as a partnership or corporation (e.g., state fees (licenses), organizational meetings, accounting services, document drafting and other legal services).

Expenses relate to creating the business entity

Does not include the selling or marketing of stock issuance

Generally incurred prior to starting the business or before the end of the first tax year

Start-up costs – expenses incurred to investigate creating or acquiring a trade or business – applies to all business forms (e.g., location costs, employee training costs).

Include costs that would normally be deductible as ordinary business expense, but the business has not started yet. Example: advertising, supplies, etc.

For organizational costs and start-up costs:

1. Deduct $5,000 immediately for organizational costs and start-up costs for a total possible deduction of $10,000 ($5,000 for organizational costs AND $5,000 for start-up costs)

a. This amount is reduced for every dollar the organizational/start-up costs exceed $50,000

2. Amortize remainder over 180 months (15 years)

**Example 9**: Sarah’s Doggy-Dog Wash, Inc. is going to begin operations on August 1, 2018. During 2018, Sarah’s Doggy-Dog Wash incurred the following expenses: legal fees for corporate charter = $38,000, accounting fees to create ledger system = $15,000, employee training costs = $3,500, and traffic pattern analysis for new storefront = $4,000. All of the costs were incurred between June 1, 2018 and July 15, 2018. How much can Sarah’s Doggy-Dog Wash deduct related to organizational and start-up costs in 2018?

**Organizational costs**

$38,000

15,000

$53,000

(2,000) immediate deduction

$51,000

(5/180) amort. percentage

1,416.67 amortized cost total deduction = $3,416.67

**Start-up costs**

$3,500

4,000

$7,500

(5,000) immediate deduction

$2,500

(5/180) amort. percentage

$69.44 amortized cost total deduction = $5,069.44