Module 3.6: Depreciation

Most taxpayers seek to maximize their deductions to minimize their tax liability in the current year. However, sometimes it is preferable to claim a smaller deduction in the current year in exchange for a larger deduction in the future. Depreciation is simply a way that we can control our taxable profits from year to year.

The reasons why you may wish to delay claiming a deduction include:

- You anticipate your income will increase in future years. Taxpayers who had lower-than-usual income in the current year or who anticipate growth in the future may wish to wait until later years when the depreciation deduction will offset income that is taxed at a higher rate.
- Or to benefit from a higher qualified business income deduction (QBID). This deduction is set to expire after 2025. Remember, it is based on a percentage of you profit, so you may want to postpone claiming depreciation in order to increase your taxable income to claim the QBIC deduction while it is still available.
- Or to obtain proof of income in the current year. Many lenders use filed income tax returns to verify a taxpayer's income. So, if you anticipate applying for a loan soon, you may want to have a tax return that shows a higher taxable income.

In the module two series, we talked about separating out all of the equipment and property purchases that had a projected life of more than one year. We then divide those that cost more than $2,500 from those who cost less. The third step is deciding how we want to depreciate those costing more than $2,500 and if we want to include any depreciable items that cost less to bump up our profits.

These are the discussions I have with my tax clients each year to control how much profit they need to show and how much tax liability they want to reduce. While we won't get into all the nuts and bolts of the subject here, my aim is to give you enough information to understand how the process works and why you need to have this conversation either with yourself or a tax professional each year.

How Depreciation Works

Machinery and other fixed assets wear out and lose value. Depreciation allows businesses to recognize this by writing off their costs over time. You can expense a portion of an asset's value each year it's used, or even deduct the entire amount at once.

Generally, any fixed asset—a long-term asset that can't easily be converted to cash—can be depreciated. This includes most of your plant, property, and equipment, with the exception of land. You can depreciate your warehouse and factory, but not the ground it's sitting on as we discussed in our module on basis. You can also depreciate intangibles such as patents and software for tax purposes.

There are two ways that you can use depreciation: as a tax deduction or as an expense that you record on your books for accounting purposes. Let's look at these two reasons to use depreciation in more detail:

Using Depreciation to Get a Tax Deduction

For tax purposes, businesses can divide the cost over several years using straight line depreciation or the Modified Accelerated Cost Recovery System (MACRS) or they can choose to deduct the entire cost of an asset all at once with bonus depreciation or the Section 179 deduction.

I*t's perfectly acceptable to use different depreciation methods for your taxes and your accounting records. Once you've decided on a method, however, you should remain consistent. I only recommend using different methods unless you have an absolute need to.*

The four primary methods the IRS lets you use to determine the allowable tax deduction for fixed assets are:

1. MACRS (Modified Accelerated Cost Recovery System): This is the primary method of depreciation that the IRS lets you use to determine the allowable tax deduction for fixed assets. In general, with MACRS, you can write off more depreciation in the early years of an asset and less in the later years.
2. Straight line depreciation: If you have intangible assets that you need to depreciate, like patents or computer software, then you would use straight line depreciation and not MACRS to calculate your tax deduction. Straight line depreciation deducts the same amount each year.
3. Section 179 deduction: If your asset qualifies for Section 179, then you can deduct up to $1 million in fixed assets in the year of purchase. This lets you receive the entire tax deduction upfront; you don't have to spread out the cost over a number of years. This can be an advantage in high profit years.
4. Bonus depreciation: Allows you to deduct 100% of the cost of assets placed in service during the years 2018 through 2022. Congress likes to play with percentage, so there have been years when it was 25%, 50% or none of the cost. It is similar to a 179 deduction, except there are fewer paperwork requirements and no $1 million limit.

Let's look at an example:

Your company buys a piece of equipment costing $1 million to help manufacture computer chips over the next 10 years. You could depreciate the equipment using the MACRS method, which would reduce your taxes in each of those years. Alternatively, you could deduct the entire cost of the equipment using either bonus depreciation or the Section 179 deduction. This would provide a large reduction in taxes your first year, but no further deduction after that.

Reporting Depreciation for Accounting Purposes

If you use the cash basis method of accounting like many small businesses, then you don't need to depreciate fixed assets for your books. You would need to depreciate for tax purposes, however. That said, if you purchase multiple assets for your business or a very expensive asset, it can throw off your books if you don't use depreciation in your accounting system.

For example:

Let's go back to our $1 million equipment example. Let's assume that before we purchased the equipment, we have revenue of $800,000 and expenses of $125,000. That will give us a net profit of $675,000.

If we depreciate the equipment using the straight line method, we will divide the $1 million evenly over 10 years to get a $100,000 annual depreciation expense. Deducting that from revenues of $800,000 and other expenses of $125,000 in the first year, that will give us a profit of $575,000.

If instead we use Section 179 or bonus depreciation to write off the entire cost of the equipment, we end up posting a $325,000 loss. That kind of loss shown on the books may give the impression your business is not doing (even though it actually is) when you talk to bank managers or investors.

So, it is sort of like a juggling act. For taxes, you may be to take the largest deduction you can upfront to reduce taxable income. For your books, you want to show a realistic and accurate bottom line for yourself, investors, and lenders. As a result, many businesses keep two sets of books: tax-adjusted basis for tax purposes and book-adjusted basis for accounting purposes. Small business accounting software can help keep everything straight, but you have to know how to set up properly which this module can help you understand.

What Assets are Depreciable?

There are certain requirements an asset must meet before you can depreciate it. You must own it, use it in your business for more than one year, and it should have a measurable useful life that is longer than one year. The five requirements to depreciate assets are:

1. The Asset Must Be Depreciable

There are some assets that the IRS says you ***can't*** depreciate, including land, inventory, leased or rented property and minor repairs you expense immediately.

An example of some items that *can* be depreciated include:

- Vehicles: cars, taxis, buses, trucks
- Office Equipment: computers, monitors, printers, copiers
- Appliances, carpet, furniture used to furnish rental real estate
- Office furniture: desks, filing cabinets
- Buildings: factory or warehouse
- Home Office Space for sole proprietors
- Intangible assets: patents and computer software
- Major repairs: any kind of improvement that restores the property, adds value to the property or adapts the property to a new purpose. Let me give you an example: Let's say you have a minor leak in the roof of your warehouse. The cost to repair the leaky roof can be expensed 100%. However, if you have to completely replace the roof after a major leak, then the roof replacement is considered an improvement. That's because it restores the property and adds value. The new roof should be set up as a fixed asset and depreciated over its useful life.

2. You Must Own the Asset

You are the owner of property, whether you paid cash, assumed a mortgage, or took out a loan to buy it. You can also depreciate leased property if it meets certain requirements.

3. The Asset Must Be Used in Your Business

While most assets are used 100% for business - there are also assets that are used for both personal and business purposes, such as a vehicle, mobile phone, or computer. In that case, you must determine the business use percentage that you can claim. For vehicles, it will be a log like we discussed before. For other items, it is based on a fair analysis of what you do.

4. The Asset Must Have Useful Life that Can be Determined

This means that the property must wear out, become obsolete, or lose its value in order to be depreciated. Certain types of property, like land, don't wear out and that's why they are not eligible for depreciation.

5. The Useful Life of the Asset Must Be Greater Than One Year

The property must not become obsolete or lose all of its value within the first 12 months. If the asset will not last for more than one year, you can just expense it on the year you purchase it and you don't have to depreciate it.

When Depreciation Starts & Ends

Knowing when depreciation starts and stops is important in calculating your allowable tax deduction. Depreciation starts when you place your property in service for use in your business. Depreciation stops when you have either fully recovered your cost or when you retire the asset from service, whichever happens first. Here are a few examples of what this means.

1. Asset Is Placed in Service

You place property in service when it is available and ready for use in your business. This normally happens when you purchase the item. However, some depreciable things need to be altered before they can be ready for business use, so the property is placed in service when it is ready and available for its intended use.

For example: On March 30, you bought a duplex to use as residential rental property. You had to make several repairs to the property to get it ready for renters. On June 1, the repairs were complete, and the duplex was ready to rent. You begin to advertise it in the local paper. The first tenants move in July 1st. However, the duplex is considered to be placed in service on June 1, when it was *ready and available* for rent.

2. Cost of the Asset Is Fully Recovered

At the other end, depreciation stops when you have fully recovered your cost in the asset or if you stop using it for business, whichever comes first. An asset is fully recovered when you have deducted the entire cost of the asset.

For example: You purchased a computer for $5,000 (including purchase price, delivery fees, and other associated costs). The computer has a useful life of five years and you will deduct $1,000 per year as depreciation expense. In this scenario, the cost of the computer will be fully recovered in the fifth year. Therefore, the computer is no longer eligible for depreciation at the end of year five.Full Recovery

3. Asset Is Retired From Service

Depreciation also stops if an asset is retired from service when it is no longer used in your business. This means you have to stop depreciating it, even if you have not fully recovered the cost. This happens in cases where the property is sold, destroyed, or otherwise no longer being used in the business

You can retire assets in the following ways:

- You sell or exchange the property.
- You convert the property to personal use.
- You abandon the property.
- You transfer the property to a supplies or scrap account.
- The property is destroyed or damaged and is no longer usable.

For example: Let's say you bought a computer for $5,000 and it had a useful life of five years. You decide to use straight line depreciation, which gives you an annual expense of $1,000. At the end of year three, you decide you're just going to use this computer for personal things, which means you sold it for zero dollars. At this point, you have retired the asset and would not be entitled to any future depreciation even though it still has a book value of $2,000.

But what happens if you sell an item you have been depreciating. Depending on the situation, you may have to recapture some of the depreciation. If the item has been fully depreciated, then you just add as income the amount you sold it for. If you haven't fully depreciated the asset, then you have some calculating to do.

For example: As in the above example, you bought a computer for $5,000 and it had a useful life of five years. You decide to use straight line depreciation, which gives you an annual expense of $1,000. At the end of year three, you decide you're just going to sell it for $3,000. It still has a book value of $2,000 so you have to pay back the extra $1,000 and add it to income. Since you bought the computer for $5,000 and sold it for $3,000, you loss of value is only $2,000. But, you have claimed $3,000 in depreciation deductions in the last three years, so you have to pay back the $1,000 make the depreciation deduction the same as the loss of value - by adding it to income. Thankfully, tax software will do all of these calculations for you.

Each year, you need to review your complete depreciation table to see if there are any items that are no longer used, thrown away, or sold and make the proper adjustments. Sometimes, if the item has been destroyed or thrown away and you haven't fully depreciated it, you can deduct the remainder of the depreciation in the current year. (Since it no longer has value, it is considered to be sold for zero dollars.) This review can thus help you control your net profit for tax purposes.

How Many Years Do You Depreciate Assets?

You should depreciate assets over their useful lives. For tax purposes, the IRS stipulates the depreciation periods for certain types of equipment in IRS Publication 946. Enclosed in that 200 page manual is a Table of Class Lives and Recovery Periods or the CLADR tables. These tell you how many years to depreciate a certain class of assets for. I've created a pdf of the CLADR tables for you to download by clicking on the link under the video. You can pause the video and download it if you want to follow along.

The tables show the asset class on the left and on the right, the number of years you may depreciate an asset depending on one of two depreciation systems: The General Depreciation System (GDS) and the Alternate Depreciation System (ADS). Most property is depreciated, by default, under the GDS system. However, you may elect the ADS system for any class of property if you want to have a longer depreciation period. For residential rental property and nonresidential real property, you may choose to use the ADS system on a property-by-property basis. For all other assets, the election to use ADS has to be made for that entire class of assets.

So, once you have determined how many years to depreciate your assets for, there are three ways to choose how to depreciate them: the 200% declining balance method, the 150% declining balance method, or straight-line depreciation. Property deducted under the 200% or 150% declining balance methods will be able to claim a larger deduction in the early years and a small deduction in the later years. (200% a little faster than 150%) Property deducted under the straight-line method will recover its cost in equal amounts each year. Here is a chart to make it a little easier to understand:

Depreciation Method	System	Eligible Property
200% declining balance	GDS	3-, 5-, 7-, and 10-year property
150% declining balance	GDS	3-, 5-, 7-, and 10-year property 15-, and 20-year property
Straight-line over GDS recovery period	GDS	3-, 5-, 7-, and 10-year property 15-, and 20-year property Residential rental property Nonresidential real property
Straight-line over Ads recovery period	ADS	Any property you chosen ADS for

As you can see, residential rental and nonresidential real property can only use straight-line recovery periods.

By knowing how many years you are going to deduct each asset and how much each year will it be (there are also tables for this in IRS Publication 946), you will actually be able to project out how much built in deductions you will have in future years to help you decide when to make future capital purchases. For instance, based on your income you may decide you don't need any more deductions this year and therefore it would be more of an advantage to wait until next year for a major purchase.

Section 179 Deduction

Section 179 of the Internal Revenue Code allows taxpayers who place eligible business assets into service to deduct it in the year it was placed into service instead of depreciating it over its class life.

Eligible property includes both new or used assets purchased for use in your business or "qualified improvement property" which is any improvement to the interior of a nonresidential building after the year it was placed in service - except enlarging the building, add an elevator or changing the internal structural framework of the building.

The maximum you can deduct for 2020 under Section 179 is $1,040,000 (It's adjusted for inflation each year). And it is reduced (dollar for dollar) by the amount by which the total cost of eligible property exceeds $2,590,000 (for 2020). You can't take the deduction at all if you've placed into service over $3,630,000 in Section 179 property during the year. Lastly, the Section 179 deduction can't be more than the business's taxable income for the year.

The great thing about the Section 179 deduction is that you don't have to deduct the entire amount of the purchase, but can 179 part of it and depreciate the remaining basis over the property's useful life. This really allows you to zero in on what you want your bottom line to be.

Special Depreciation Allowance

Our forth basic way to deduct assets is the Special Depreciation Allowance, sometimes called the "bonus depreciation".   It is available in the year qualifying property is placed into service for use in a trade or business.

The deduction is based on a percentage of the cost of the asset (usually 50% or 100%). For 2021, it is 100% of the cost of qualifying property place in service during the tax year.

Qualified property is generally tangible property with a MACRS recovery period of 20 years or less, depreciable software, and "qualified improvement property".

In addition, the asset must pass either of two tests:

- The property was first acquired during the tax year. You may have not used it for any other purpose prior to placing it in service for the business.
- No one else may have used the property before the taxpayer placed it into service.

The problem with the special depreciation is that it is automatically applied to all qualifying property unless you Opt-Out. So, in a situation where you do not to reduce your profit that much, you need to add a statement to your business return indicating you want to opt-out of the special depreciation and the class of property that this election applies to.

The class of property stipulation means that if you opt-out of one five year property, you must opt-out of all five year property. If you opt-out of one 10 year property, then you have to opt-out of all 10 year property, and so forth. Again, any good tax software will create this opt-out election statement for you.

So, depending on what you placed into service for the year, you can really use the Section 179 and the special depreciation options to control how much tax liability you have for the year.

Failure to Claim Depreciation

One of the first things I do when working with a new business client is ask for a copy of their prior year tax return. This tell me many things, such as if they had any depreciation deductions for the previous year. I need to recreate the depreciation tables to make sure my clients get the rest of the depreciation they deserve and how many years each asset still has.

But sometimes I get a new client that has been doing the taxes themselves or had hired a tax preparer that did not have the proper knowledge and there is no depreciation table. One of the most common mistakes where this is made is when a homeowner buys property and turns that or their own home into rental property. They know nothing about depreciation like you do now and just don't deduct it.

The problem is that taxpayers who place depreciable assets into service and fail to claim the depreciation deduction for those assets may find that they face a penalty for that failure when the asset is sold.

This is because, each year, an asset's basis is reduced by the amount of depreciation "allowed or allowable" depreciable life of the asset. That means you have to claim the depreciation even if you did not take it when you sell the asset.

For example: You inherit a rental house on June 13, 2016, that you immediately place into service (rented). The fair market value at the time you inherited it was $200,000. You sold the house in June of 2021 for $195,000. But knowing the depreciation rules, you failed to claim a depreciation deduction for the property during any of the time that you were renting the property.

Your basis in the property will be reduced by the depreciation you could have claimed while the property was in service, and you will required to report a taxable gain on your 2021 return. That is about $36,364 in depreciation you did not take which reduced your basis in the property to $163,636 and with a selling price of $195,000, that is a profit of $31,364 you have to pay taxes on. But you have overpaid taxes for the last five years because you didn't claim depreciation.

Thankfully, you weren't to sure how to handle the sale of rental property and decided to go to a tax preparer that knew how to fix it. Taxpayers may generally correct this error by claiming "catch up" depreciation by filing Form 3115, Application for Change in Accounting Method, and reporting the difference on the current year's form. In this example, the Form 3115 would be filed with your 2021 return. It generally can't be corrected on an amended return. This is a complex form used for a variety of things, so I wouldn't recommend trying to do it yourself.

The Tangible Property Regulations and Taxpayer Elections

We are going to end up this module talking about what you don't need to depreciate. Before jumping into the planning opportunities provided by the Tangible Property Regulations (TPRs), let's start with a quick review on their role in the larger body of tax law governing depreciation.

The Problem

Section 162 of the IRS code allows taxpayers to deduct the cost of "ordinary and necessary" business expenses, in full, in the year that the expenses are paid. This includes the cost of "materials and supplies" and of "repairs and maintenance."

On the other hand, Section 263 (a) requires taxpayers to capitalize the costs of acquiring, producing and improving tangible property.

So taxpayers were trying reconcile two conflicting laws and the depreciation tables were becoming huge because everything with a life of more than a year was being capitalized and depreciated.

The Solution?

Finalized in 2013, the TRPs attempted to reconcile this conflict by providing uniform guidance on a what were business's deductibles and what were capital costs that needed to be depreciated. They also added a couple of elections and safe harbors.

This greatly reduced the amount of paperwork that a business had to do, reduced the size of depreciation tables and helped businesses reduce their tax burden by taking advantage of the elections, to either maximize their current-year deductions or to defer deductions until later years - whichever makes you more profitable.

There are now three different elections for businesses that have expenses for repairs, maintenance, and improvements:

1. Election to Capitalize Repairs and Maintenance allows you to capitalize repairs and maintenance that you would normally just deduct if you treat them as capital expenses on your books. This may be decided year-by-year so could come in handy if you want to increase the profit shown on the books in a particular year. This is election 1.263(a)-3(n).

2. Small Taxpayers with Eligible Buildings allows a small taxpayer who make improvements to eligible buildings to treat those improvements as deductible repairs if the total cost

during the year for repairs, maintenance, improvements, and similar activities performed on the building is less than both of the following:

- $10,000
- 2% of he building's adjusted basis
- The unadjusted basis of the building may not be more than $1,000.000.
- An "eligible building" includes a building owned outright by the taxpayer, a condo, a co-op or a building leased by the taxpayer. A "small taxpayer" is one whose average annual gross receipts one the last three years are less than or equal to $10 million.
  This would be an option if you need to reduce the amount of profit that you made in a particular year

3. De Minimis Safe Harbor Election is the most used of the three elections. It allows you to deduct costs that are under certain dollar amounts, even if these costs otherwise would be required to be capitalized. For most taxpayers, this election is available if the following requirements are met:

   - The property costs $2,500 or less per item
   - The taxpayer has an accounting system in place at the beginning of the tax year in which the taxpayer makes the election. This applied to the vast majority of small businesses.

   Certain taxpayers that are required to produce financial statements, such as audited financial statements, must meet different rules:

   - The property costs $5,000 or less per item
   - They must have an accounting system in place to make the election, but it must be in writing.

   To take the Safe Harbor election, you must attach a statement to a timely filed original return titled: "Section 1.263(a)-1 De Minimis Safe Harbor Election", include your name, address, and taxpayer identification number, and include a statement that you are making the de miminis safe harbor election under Trees. Reg. Section 1.263(a)-1(f). Most good tax software will have a box you can check that will create this attachment for you.

Final Thoughts

There is a whole lot more that could be learned about how you handle assets and property under the depreciation rules. My purpose here was to show you how the tax laws can be used to control how much profit you show and/or how much tax you pay - as well as the problems associated by not doing it doing it correctly.   If you decide to use a tax professional for your business taxes, these are the subjects that they should be discussing with you.