

[LO 1]{Research} Emily purchased a building to store inventory for her business. The purchase price was \$760,000. Emily also paid legal fees of \$300 to acquire the building. In March, Emily incurred \$2,000 to repair minor leaks in the roof (from storm damage earlier in the month) and \$5,000 to make the interior suitable for her finished goods. What is Emily's cost basis in the new building?

*\$765,300 cost basis, computed as follows:*

<i>Description</i>	<i>Amount</i>	<i>Explanation</i>
<i>Purchase price</i>	<i>\$760,000</i>	
<i>Improvements</i>	<i>5,000</i>	<i>Business preparation costs</i>
<i>Legal fees</i>	<i>300</i>	<i>Business preparation costs</i>
<i>Cost basis in building</i>	<i>\$765,300*</i>	

*\*Note that the \$2,000 repair for the roof was not capitalized. The repair is likely a routine maintenance expenditure rather than a capitalized cost under Reg. 1.263(a)-3. The roof repair is reasonably expected to occur more than once in a 10-year period. However, if the expense resulted in a betterment, restoration, or adaptation to new or different use, it would be capitalized. The legal fees would be capitalized as expenses to purchase the building and the costs to modify the interior would be capitalized as improvement costs.*

LO 2, LO 3] Evergreen Corporation (calendar-year-end) acquired the following assets during the current year:

<u>Asset</u>	<u>Placed in Service Date</u>	<u>Original Basis</u>
Machinery	October 25	\$70,000
Computer equipment	February 3	10,000
Used delivery truck*	August 17	23,000
Furniture	April 22	150,000

\*The delivery truck is not a luxury automobile.

- What is the allowable depreciation on Evergreen's property in the current year, assuming Evergreen does not elect §179 expense and elects out of bonus depreciation?
- What is the allowable depreciation on Evergreen's property in the current year if Evergreen does not elect out of bonus depreciation and elects out of §179 expense?

*a. \$38,038, under the half-year convention, calculated as follows:*

<u>Asset</u>	<u>Placed in Service</u>	<u>(1) Original Basis</u>	<u>(2) Rate</u>	<u>(1) × (2) Depreciation</u>
<i>Computer equipment (5 year)</i>	<i>February 3</i>	<i>\$10,000</i>	<i>20.00%</i>	<i>\$2,000</i>

Furniture (7 year)	April 22	150,000	14.29%	21,435
Used delivery truck (5 year)	August 17	23,000	20.00%	4,600
Machinery (7 year)	October 25	<u>70,000</u>	14.29%	<u>10,003</u>
Total		\$253,000		<u>\$38,038</u>

\$253,000, using 100 percent bonus depreciation. All of Evergreen's assets placed in service during the year are eligible for bonus depreciation of 100 percent.

<u>Asset</u>	<u>Placed in Service</u>	<u>(1) Original Basis</u>	<u>(2) Bonus Depreciation (1) × 100%</u>	<u>(3) Remaining Basis</u>	<u>(4) MACRS Rate</u>	<u>(3) × (4) Depreciation</u>
Computer equipment (5 year)	February 3	\$10,000	\$10,000	\$-0-	20%	\$-
Furniture (7 year)	April 22	150,000	150,000	-0-	14.29%	-
Used delivery truck (5 year)	August 17	23,000	23,000	-0-	20%	-
Machinery (7 year)	October 25	<u>70,000</u>	<u>70,000</u>	-0-	14.29%	-
Bonus depreciation						<u>253,000</u>
Total		\$253,000				<u>\$253,000</u>

1. [LO 4] Juliette formed a new business to sell sporting goods this year. The business opened its doors to customers on June 1. Determine the amount of start-up costs Juliette can immediately expense (not including the portion of the expenditures that are amortized over 180 months) this year in the following alternative scenarios.
  - a. She incurred start-up costs of \$2,000.
  - a. She incurred start-up costs of \$45,000.
  - b. She incurred start-up costs of \$53,500.
  - c. She incurred start-up costs of \$63,000.
  - d. How would you answer parts (a) through (d) if she formed a partnership or a corporation and she incurred the same amount of organizational expenditures rather than start-up costs (how much of the organizational expenditures would be immediately deductible)?

a. \$2,000, computed as follows:

<i>Start-up Expenses</i>		
<i>Description</i>	<i>Amount</i>	<i>Explanation</i>
(1) Maximum immediate expense	\$5,000	
(2) Total start-up costs	\$2,000	Given in problem
(3) Phase-out threshold	<u>50,000</u>	
(4) Immediate expense phase-out	\$0	(2) - (3)
<b>Allowable immediate expense</b>	<b>\$2,000</b>	Lesser of (2) or [(1) minus - (4)]

b. \$5,000, computed as follows:

<i>Start-up Expenses</i>		
<i>Description</i>	<i>Amount</i>	<i>Explanation</i>
(1) Maximum immediate expense	\$5,000	
(2) Total start-up costs	\$45,000	Given in problem
(3) Phase-out threshold	<u>50,000</u>	

(4) Immediate expense phase-out	\$0	(2) – (3), not less than \$0
<b>Allowable immediate expense</b>	<b>\$5,000</b>	Lesser of (2) or [(1) minus – (4)]

c. \$1,500, computed as follows:

<b>Start-up Expenses</b>		
<b>Description</b>	<b>Amount</b>	<b>Explanation</b>
(1) Maximum immediate expense	\$5,000	
(2) Total start-up costs	\$53,500	Given in problem
(3) Phase-out threshold	<u>50,000</u>	
(4) Immediate expense phase-out	\$3,500	(2) – (3), not less than \$0
<b>Allowable immediate expense</b>	<b>\$1,500</b>	Lesser of (2) or [(1) minus – (4)]

d. \$0, computed as follows:

<b>Organizational Expenditures</b>		
<b>Description</b>	<b>Amount</b>	<b>Explanation</b>
(1) Maximum immediate expense	\$5,000	
(2) Total start-up costs	\$63,000	Given in problem
(3) Phase-out threshold	<u>50,000</u>	
(4) Immediate expense phase-out	\$13,000	(2) – (3), not less than \$0
<b>Allowable immediate expense</b>	<b>\$0</b>	Lesser of (2) or [(1) minus – (4)] (not less than \$0)

e. The answers would be the same if these were organizational expenditures instead of start-up costs. Note, however, that organizational expenditures only apply to corporations and partnerships and do not apply to businesses organized as sole proprietorships.

[LO 5] Last Chance Mine (LCM) purchased a coal deposit for \$750,000. It estimated it would extract 12,000 tons of coal from the deposit. LCM mined the coal and sold it, reporting gross receipts of \$1 million, \$3 million, and \$2 million for years 1 through 3, respectively. During years 1 – 3, LCM reported net income (loss) from the coal deposit activity in the amount of (\$20,000), \$500,000, and \$450,000, respectively. In years 1 – 3, LCM extracted 13,000 tons of coal as follows:

(1) Tons of Coal	(2) Basis	Depletion (2)/(1) Rate	Tons extracted per year		
			Year 1	Year 2	Year 3
12,000	\$750,000	\$62.50	2,000	7,200	3,800

- What is LCM's cost depletion for years 1, 2, and 3?
- What is LCM's percentage depletion for each year (the applicable percentage for coal is 10 percent)?
- Using the cost and percentage depletion computations from parts (a) and (b), what is LCM's actual depletion expense for each year?

- f. LCM's cost depletion is \$125,000 for year 1, \$450,000 for year 2, and \$175,000 for year 3, calculated as follows:

	Year 1	Year 2	Year 3	Explanation
(1) Tons extracted	2,000	7,200	3,800	
(2) Depletion rate	\$62.50	\$62.50	\$62.50	
<b>Cost Depletion Expense</b>	<b>\$125,000</b>	<b>\$450,000</b>	<b>\$175,000*</b>	(1) × (2)

\*This is the remaining basis. Under the cost depletion method, the taxpayer's amortization is limited to the cost basis in the natural resource. The full amount of amortization would have been \$237,500 if this were not the case.

- g. LCM's percentage depletion for each year is calculated as follows:

	Year 1	Year 2	Year 3	Explanation
(1) Net income from activity (before depletion expense)	(\$20,000)	\$500,000	\$450,000	Given in problem
(2) Gross Income	\$1,000,000	\$3,000,000	\$2,000,000	
(3) Percentage	<u>× 10%</u>	<u>× 10%</u>	<u>× 10%</u>	
(4) Percentage Depletion Expense before limit	\$100,000	\$300,000	\$200,000	(2) × (3)
(5) 50% of net income limitation	\$0	\$250,000	\$225,000	(1) × 50%
<b>Allowable percentage depletion</b>	<b>\$0</b>	<b>\$250,000</b>	<b>\$200,000</b>	Lesser of (4) or (5)

Note that percentage depletion is not limited to the basis in the property.

- h. Depletion expense is the greater of cost depletion or percentage depletion calculated as follows:

**Tax Depletion Expense**

	Year 1	Year 2	Year 3	Explanation
(1) Cost depletion	\$125,000	\$450,000	\$175,000	Part a
(2) Percentage depletion	<u>\$0</u>	<u>\$250,000</u>	<u>\$200,000</u>	Part b
<b>Deductible depletion expense</b>	<b>\$125,000</b>	<b>\$450,000</b>	<b>\$200,000</b>	Greater of (1) or (2)

