

Lecture Notes

- 1) Cost Recovery and Tax Basis for Cost Recovery
 - a) For financial accounting and tax accounting purposes, businesses must capitalize the cost of assets with a useful life of more than one year (on the balance sheet) rather than expense the cost immediately.
 - b) Methods used to recover the cost of assets through cost recovery deductions:
 - i) Depreciation
 - ii) Amortization
 - iii) Depletion
 - iv) Refer to Exhibit 10-1 for Assets and Cost Recovery and Exhibit 10-2 for Weyerhaeuser Assets.
 - c) Basis for cost recovery
 - i) Businesses may begin recouping the cost of purchased business assets once they begin using the asset in their business (place it in service).
 - ii) The amount of an asset's cost that has yet to be recovered through cost recovery deductions is called the asset's adjusted basis or tax basis.
 - (1) Asset's Adjusted Basis = Asset's Initial Cost or Historical Cost minus Accumulated Depreciation (or Amortization or Depletion)
 - iii) Cost basis is usually the same for book and tax purposes (although exceptions exist).
 - iv) An asset's cost basis includes all expenses needed to purchase the asset, prepare it for use, and begin using it.
 - (1) Work through Example 10-1.
 - v) Repair regulations provide guidance on whether costs incurred after acquisition should be capitalized or immediately deducted. Several safe harbors exist: *de minimis* and routine maintenance for example.
 - (1) Work through Example 10-2.
 - vi) Special basis rules apply when personal assets are converted to business use and when assets are acquired through nontaxable transactions, gifts, or inheritances.
- 2) Depreciation
 - a) Businesses use MACRS (Modified Accelerated Cost Recovery System) along with special depreciation allowances (§179 expensing, bonus depreciation, and listed property) to determine their tax depreciation.
 - b) To compute MACRS depreciation for an asset, the business need only know:
 - i) The asset's depreciable basis
 - ii) The date the asset was placed in service
 - iii) The applicable depreciation method
 - iv) The asset's recovery period
 - v) The applicable depreciation convention
 - c) Personal property depreciation
 - i) Includes all tangible property, such as computers, automobiles, furniture, machinery, and equipment, other than real property.
 - ii) Personal property is relatively short-lived and subject to obsolescence when compared to real property.
 - iii) Depreciation method
 - (1) MACRS provides three acceptable methods for depreciating personal property:
 - (a) 200 percent (double) declining balance (default method);
 - (b) 150 percent declining balance; and
 - (c) Straight-line.
 - (2) Work through Example 10-3.

- iv) Depreciation recovery period
 - (1) For financial accounting purposes, an asset's recovery period (depreciable life) is based on its taxpayer-determined estimated useful life.
 - (2) For tax purposes, an asset's recovery period is predetermined by the IRS in the Rev. Proc. 87-56, which helps taxpayers to categorize each of their assets based upon the property's description.
 - (a) Refer to Exhibit 10-3 for Excerpt from Revenue Procedure 87-56.
 - (b) Refer to Exhibit 10-4 for Recovery Period for Most Common Business Assets.
 - (c) Refer to Exhibit 10-5 for Teton Personal Property Summary (Base Scenario).
- v) Depreciation Conventions
 - (1) The convention specifies the portion of a full year's depreciation the business can deduct for an asset in the year the asset is first placed in service and in the year the asset is sold.
 - (2) For personal property, taxpayers must either use the half-year convention or the mid-quarter convention.
 - (a) Half-year convention
 - (i) One-half of a year's depreciation is allowed in the first and the last year of an asset's life.
 - (ii) The IRS depreciation tables automatically account for the half-year convention.
 - 1. Refer to Table 1 in Appendix A for MACRS Half-Year Convention.
 - 2. Work through Example 10-4 .
 - (b) Mid-quarter convention
 - (i) The mid-quarter convention is required when more than 40 percent of a taxpayer's total tangible personal property placed in service during the year was placed during the fourth quarter.
 - (ii) The IRS depreciation tables have built in the mid-quarter convention to simplify the calculations.
- vi) Calculating depreciation for personal property
 - (1) IRS provides depreciation percentage tables in Rev. Proc. 87-57.
 - (2) Steps to determine the depreciation for an asset for the year:
 - (a) Determine the appropriate convention (half-year or mid-quarter) by determining whether more than 40 percent of qualified property was placed in service in the last quarter of the tax year.
 - (b) Locate the applicable table provided in Rev. Proc. 87-57 (reproduced in Appendix A of this chapter).
 - (c) Select the column that corresponds with the asset's recovery period.
 - (d) Find the row identifying the year of the asset's recovery period.
- vii) Applying the half-year convention
 - (1) Work through Example 10-5.
 - (2) Half-year convention for year of disposition
 - (a) Work through Example 10-6.
- viii) Applying the mid-quarter convention
 - (1) Work through Example 10-7.
 - (2) Refer to Tables 2a-d in Appendix A for Mid-Quarter Convention Tables.
 - (3) Mid-quarter convention for year of disposition
 - (a) Work through Example 10-8.
- d) Real property
 - i) Real property is depreciated using the straight-line method.
 - ii) Real property uses the mid-month convention.
 - iii) Residential property has a recovery period of 27.5 years.
 - iv) Nonresidential property placed in service on or after May 13, 1993, has a life of 39 years.

- v) Nonresidential property placed in service after December 31, 1986, but before May 13, 1993, has a recovery period of 31.5 years.
 - vi) Refer to Exhibit 10-7 for Recovery Period for Real Property.
 - vii) Applicable method
 - (1) All depreciable real property is depreciated for tax purposes using the straight-line method.
 - viii) Applicable convention
 - (1) All real property is depreciated using the mid-month convention.
 - ix) Depreciation tables
 - (1) Work through Example 10-9.
 - (2) Mid-month convention for year of disposition
 - (a) Process for calculating mid-month convention depreciation for the year of sale:
 - (i) Determine the amount of depreciation deduction for the asset as if the asset were held for the entire year.
 - (ii) Subtract one-half of a month from the month in which the asset was sold (if sold in third month, subtract .5 from 3 to get 2.5). (Subtract half of a month because the business is treated as though the asset was disposed of in the middle of the third month—not the end.)
 - (iii) Divide the amount determined in Step 2 by 12 months (2.5/12). This is the fraction of the full year's depreciation the business is eligible to deduct.
 - (iv) Multiply the Step 3 outcome by the full depreciation determined in Step 1.
 - (v) Formula: Mid-month depreciation for year of disposition = Full-year's depreciation \times ((Month in which asset was disposed of - 0.5)/12)
 - (vi) Work through Example 10-10.
- 3) Special Rules Relating to Cost Recovery
- a) Immediate expensing (§179)
 - i) Policy makers created §179 as an incentive to help small businesses purchasing qualified property. This incentive is commonly referred to as the §179 expense or immediate expensing election.
 - ii) Qualified real property means improvements to nonresidential real property placed in service after the date the building was placed in service, including roofs; heating, ventilation, and air-conditioning; fire protection and alarm systems; and security systems.
 - iii) Work through Example 10-11.
 - iv) Limits on immediate expensing
 - (1) The maximum amount of §179 expense a business may elect to claim for the year is subject to a phase-out limitation.
 - (2) \$2,500,000 of tangible personal property may be immediately expensed in 2025.
 - (3) Businesses are eligible for the full amount of this expense when tangible personal property placed in service is less than \$4,000,000 for 2025. Beginning at \$4,000,000, the §179 expense is phased out, dollar for dollar. When assets placed in service exceed \$6,500,000, no §179 expense can be taken. Both the amount of §179 allowed and the property limitation are indexed for inflation and change each year.
 - (a) Work through Examples 10-12 and 10-13.
 - (4) §179 expenses are also limited to a business's taxable income before the §179 expense. §179 expenses cannot create losses.
 - v) Choosing the assets to immediately expense
 - (1) Businesses qualifying for immediate expensing can choose the asset or assets (from tangible personal property placed in service during the year) they immediately expense under §179.

- (2) If a business's objective is to maximize its current depreciation deduction, it should immediately expense the asset with the lowest first-year cost recovery percentage including bonus depreciation (discussed in the next section).
- vi) Bonus depreciation
 - (1) Since 2001, businesses have had the ability to immediately deduct a percentage of the acquisition cost of qualifying assets under rules known as bonus depreciation.
 - (2) The percentage allowable for each tax year during this period has changed many times, ranging from 30 percent to 100 percent.
 - (3) The OBBBA made bonus depreciation a permanent provision, and for property placed in service after January 19, 2025 the percentage is 100 percent. For assets placed in service in 2025 before January 20, 2025 the bonus percentage is 40 percent. The OBBBA also provides an election for taxpayers that do not want to immediately return to 100 percent bonus to elect a reduced bonus depreciation rate of 40 percent during the first tax year ending after January 19, 2025.
 - (4) Bonus depreciation is mandatory for all taxpayers that qualify. However, taxpayers may elect out of bonus depreciation (on a property class basis) by attaching a statement to their tax return indicating they are electing not to claim bonus depreciation.
 - (5) Refer to Exhibit 10-9 for Bonus Depreciation Percentages.
 - (6) Qualified property
 - (i) Taxpayers must first determine whether the assets acquired during the year are eligible for bonus depreciation. To qualify, property must be new or used property (as long as the property has not previously been used by the taxpayer within the past five years) and must generally have a regular depreciation life of 20 years or less.
 - (b) Qualified improvement property (15-year property) qualifies for bonus depreciation if the improvements are made by the taxpayer after the building was first placed in service by the taxpayer (Reg §1.168(b)-1(a)(5)(i)(A)).
 - (7) When taxpayers claim §179 expense and bonus depreciation, §179 is determined first, then bonus depreciation, and finally regular MACRS is calculated on the remaining basis.
 - (8) Work through Example 10-14.
- b) Special depreciation allowance for qualified production property
 - i) The OBBBA created an increased depreciation allowance for qualified production property (QPP).
 - ii) QPP refers to nonresidential real property placed in service in the U.S. that is used for a qualified production activity in the U.S. or possession of the U.S. Similar to the rules under §179, QPP does not include property with prior use by the taxpayer.
 - iii) Taxpayers may elect to take a deduction of 100 percent of the adjusted basis of the property and must reduce the adjusted basis of the QPP by the amount of the depreciation deduction taken.
 - iv) The special depreciation deduction applies to QPP placed in service after July 4, 2025. Taxpayers must make an election to take advantage of the special deduction and QPP is treated as a separate class of property.
 - v) Work through Example 10-15.
- c) Listed property
 - i) When an asset is used for both personal and business use, calculate the business-use percentage.
 - ii) If the business-use percentage is above 50 percent, the allowable depreciation is limited to the business-use percentage.
 - iii) If a listed property's business-use percentage ever falls to or below 50 percent, depreciation for all previous years is retroactively restated using the MACRS straight-line method.

- iv) Work through Example 10-16 and 10-17.
- v) Businesses can use the following five steps to determine its current depreciation expense for the asset when business use falls to 50 percent or below:
 - (1) Compute depreciation for the year it drops to 50 percent or below using the straight-line method (this method also applies to all subsequent years).
 - (2) Compute the amount of depreciation the taxpayer would have deducted if the taxpayer had used the straight-line method over the ADS recovery period for all prior years (recall that depreciation is limited to the business-use percentage in those years).
 - (3) Compute the amount of depreciation (including §179 and bonus depreciation) the taxpayer deducted on the asset for all prior years.
 - (4) Subtract the amount from Step 2 from the amount in Step 3. The difference is the prior-year accelerated depreciation in excess of straight-line depreciation.
 - (5) Subtract the excess accelerated depreciation determined in Step 4 from the current-year straight-line depreciation in Step 1. This is the business's allowable depreciation expense on the asset for the year. If the prior-year excess depreciation from Step 4 exceeds the current-year straight-line depreciation in Step 1, the business is not allowed to deduct any depreciation on the asset for the year and must recognize additional ordinary income for the excess.
 - (6) Work through Example 10-18.
- vi) Luxury automobiles
 - (1) Depreciation on automobiles weighing less than 6,000 pounds is subject to luxury auto provisions.
 - (2) Luxury automobiles have a maximum depreciation limit for each year.
 - (3) Listed property rules are also applicable to luxury automobiles.
 - (4) Refer to Exhibit 10-10 for Automobile Depreciation Limits.
 - (5) Each year, the IRS provides a maximum depreciation schedule for automobiles placed in service during that particular year. In 2025, taxpayers can deduct \$8,000 of bonus depreciation above the otherwise allowable maximum depreciation (maximum depreciation of \$20,200).
 - (6) Work through Example 10-19.
 - (7) Automobiles and §179
 - (a) Businesses may deduct §179 expensing on luxury automobiles, but the luxury car limitation in 2025 is \$12,200, and this limit applies regardless of whether the taxpayer claims regular MACRS depreciation or §179 expensing on the car.
 - (b) For cars that cost more than \$61,000, the taxpayer doesn't benefit by electing §179 because the regular MACRS depreciation deduction would be greater than \$12,200 and would be limited to \$12,200.
 - (c) For cars that cost less than \$61,000, taxpayers could benefit by electing to take \$12,200 of §179 expense on the car to boost the depreciation deduction in the first year.
 - (8) Automobiles and bonus depreciation
 - (a) For passenger cars (automobiles weighing 6,000 pounds or less), the luxury automobile limitations still apply. With bonus depreciation, taxpayers are allowed to increase the limitation in the first year by \$8,000, making the first-year limit \$20,200 in 2025.
 - (b) However, in years 2–6 (recovery period for passenger cars), taxpayers must again compare the regular MACRS amount in each year to the automobile limitation in Exhibit 10-10 for the year.
 - (c) If the taxpayer claims bonus depreciation, then, much of the allowable depreciation was taken in year 1 (40 percent bonus depreciation) even though the taxpayer was

limited by the automobile limitations. This means that there is very little regular depreciation remaining for years 2–6.

- (d) Fortunately, the IRS provides a way (safe harbor) for taxpayers to continue to take additional depreciation in years 2–6 when they claim bonus depreciation. This method applies to automobiles that have an initial basis greater than \$50,500 (the first-year depreciation limitation for luxury automobiles of \$20,200/40 percent) when taxpayers have not elected out of bonus depreciation.

(9) Work through Examples 10-20 and 10-21.

- d) Depreciation for the alternative minimum tax
 - i) For AMT purposes, the allowable recovery period and conventions are the same for all depreciable assets as they are for regular tax purposes.
 - ii) The difference between regular tax depreciation and AMT depreciation is an adjustment that is either added to or subtracted from regular taxable income in computing the alternative minimum tax base.
 - e) Depreciation summary
 - i) Refer to Exhibit 10-11 for Teton’s 2024 Depreciation Expense and 10-12 for Teton’s Form 4562 Parts I–IV for Depreciation.
- 4) Amortization
- a) Businesses recover the cost of intangible assets through amortization rather than depreciation.
 - b) For tax purposes, an intangible asset can be placed into one of the following four general categories:
 - i) §197 purchased intangibles
 - ii) Organizational expenditures and start-up costs
 - iii) Research and experimentation costs
 - iv) Patents and copyrights
 - c) Section 197 intangibles
 - i) §197 intangibles have a recovery period of 180 months (15 years), regardless of their actual life.
 - ii) The full-month convention applies to amortizable assets, which allows taxpayers to deduct an entire month’s worth of amortization for the month of purchase and all subsequent months in the year.
 - iii) Work through Example 10-22.
 - d) Organizational expenditures and start-up costs
 - (1) Organizational expenditures include expenditures to form and organize a business in the form of a corporation or an entity taxed as a partnership.
 - (2) Start-up costs are costs businesses incur to start up a business.
 - (3) Refer to Exhibit 10-13 for Summary of Timing for Organizational Expenditures, Start-up Costs, and Normal Trade or Business Expenses.
 - (4) Businesses may immediately expense up to \$5,000 of organizational expenditures.
 - (5) However, corporations and partnerships incurring more than \$50,000 in organizational expenditures must phase out (reduce) the \$5,000 immediate expense amount dollar-for-dollar for expenditures exceeding \$50,000. Thus, businesses incurring at least \$55,000 of organizational expenditures are not allowed to immediately expense any of the expenditures.
 - (6) The rules for immediately expensing and amortizing start-up costs are the same as those for immediately expensing and amortizing organizational expenditures. Consequently, businesses incurring at least \$55,000 of start-up costs are not allowed to immediately expense any of the costs.
 - (7) Work through Examples 10-23 to 10-26.
 - e) Research and experimentation expenditures

- i) Businesses often invest in activities they believe will generate innovative products or significantly improve their current products or processes.
 - (1) Includes expenditures for research laboratories, including salaries, materials, and other related expenses
 - (2) The tax treatment of R&E expenditures depends on whether the costs are incurred for research domestically or outside of the U.S.
 - (3) Domestic R&E
 - (a) Taxpayers may elect to immediately deduct these expenditures or to capitalize and amortize them over a period not less than 60 months beginning with the month in which the taxpayer receives benefit from the expenditures.
 - (b) Businesses that incurred R&E expenditures after December 31, 2021 and before January 1, 2025 were required to capitalize and amortize the costs. The OBBBA gives taxpayers an option to elect to deduct unamortized costs from this period in their first tax year beginning after December 31, 2024 or to deduct the unamortized costs ratably over the two tax year period beginning with the first tax year that begins after December 31, 2024.
 - (c) Another benefit provided by the allows small businesses, generally average gross receipts of \$31 million or less, can elect to apply the new law retroactively for expenditures incurred after December 31, 2021.
 - (4) Foreign R&E
 - (a) Research and experimentation expenditures attributable to research conducted *outside* the United States are capitalized and amortized ratably over a period of 15 years using the mid-year convention.
 - f) Patents and copyrights
 - i) The way a business amortizes a patent or copyright depends on whether the business directly purchases the patent or copyright or whether it self-creates the intangibles.
 - ii) Work through Example 10-25.
 - g) Amortizable intangible asset summary
 - i) Refer to Exhibit 10-14 for Summary of Amortizable Assets.
 - ii) Refer to Exhibit 10-15 for Teton Form 4562, Part VI Amortization of Organizational Expenditures and Patent.
- 5) Depletion
- a) The method taxpayers use to recover their capital investment in natural resources.
 - b) It is a particularly significant deduction for businesses in the mining, oil and gas, and forestry industries.
 - c) Cost depletion involves estimating resource reserves and allocating a pro rata share of basis based on the number of units extracted.
 - d) Percentage depletion is determined by a statutory percentage of gross income that is permitted to be expensed each year. Different resources have different statutory percentages (i.e., gold, tin, coal).
 - e) Taxpayers may expense the larger of cost or percentage depletion.
 - f) Work through Examples 10-26, 10-27, and 10-28.
 - g) Refer to Exhibit 10-16 for Applicable Percentage Depletion Rates.