Department of the Treasury
Internal Revenue Service

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How To Depreciate Property

- **Section 179 Deduction**
- **Special Depreciation Allowance**
- **MACRS**
- **Listed Property**

For use in preparing

2004 Returns

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What's New

Increased section 179 deduction dollar limit. The maximum amount you can elect to deduct for most section 179 property you placed in service during 2004 is $102,000. This limit is reduced by the amount by which the cost of the property placed in service during the tax year exceeds $410,000. See *Dollar Limits* under *How Much Can You Deduct* in chapter 2.

Section 179 deduction limit for sport utility and certain other vehicles. The maximum section 179 expense deduction for sport utility vehicles and certain other vehicles placed in service after October 22, 2004, is $25,000. For more information, see *Section 179 Deduction Limit for Sport Utility and Certain Other Vehicles* in chapter 2.

Bonus depreciation for aircraft. Certain non-commercial aircraft placed in service before January 1, 2006, are eligible for the special depreciation allowances. See *What Is Qualified Property* in chapter 3.

Election out for qualified New York Liberty Zone (Liberty Zone) leasehold improvement property. You can elect not to treat certain qualified Liberty Zone leasehold improvement property as 5-year property. For more information, see *Which Property Class Applies Under GDS* in chapter 4.

Recovery period for qualified leasehold improvement and qualified restaurant property. Qualified leasehold improvement property and qualified restaurant property placed in service after October 22, 2004, and before January 1, 2006, are treated as 15-year property under MACRS. See *Figuring Depreciation Under MACRS* in chapter 4.

Depreciation deduction for property acquired in a nontaxable exchange. New guidance has been issued for depreciating MACRS property acquired after February 27, 2004 in a like-kind exchange or involuntary conversion. See *Figuring the Deduction for Property Acquired in a Nontaxable Exchange* in chapter 4.

Depreciation limits on business vehicles. The total section 179 deduction and depreciation (including the special depreciation allowance) you can deduct for a passenger automobile (that is not an electric vehicle or a truck or van) you use in your business and first placed in service in 2004 is generally $10,610. The maximum deduction for an electric vehicle is generally $31,830. The maximum deduction you can take for a truck or van you use in your business and first placed in service in 2004 is generally $10,910. See *Maximum Depreciation Deduction* in chapter 5.

Important Reminders

Photographs of missing children. The Internal Revenue Service is a proud partner with the National Center for Missing and Exploited Children. Photographs of missing children selected by the Center may appear in this publication on pages that would otherwise be blank. You can help bring these children home by looking at the photographs and calling 1-800-THE-LOST (1-800-843-5678) if you recognize a child.

Additional special depreciation allowances. The additional special depreciation allowances will not apply to most property placed in service after December 31, 2004. For more information, see *Claiming the Special Depreciation Allowance (or Liberty Zone Depreciation Allowance)* in chapter 3.

Introduction

This publication explains how you can recover the cost of business or income-producing property through deductions for depreciation (the special depreciation allowance, the special Liberty Zone depreciation allowance, and deductions under the Modified Accelerated Cost Recovery System). It also explains how you can elect to take a section 179 deduction, instead of depreciation deductions, for certain property and the additional rules for listed property. In addition, the publication describes how to figure depreciation and how to fill out Form 4562, Depreciation and Amortization.

CAUTION *The depreciation methods discussed in this publication generally do not apply to property placed in service before 1987. If you want information about depreciating such property, see Publication 534.*

Definitions. Many of the terms used in this publication are defined in the *Glossary* near the end of the publication. Glossary terms used in each discussion under the major headings are listed before the beginning of each discussion throughout the publication.

Do you need a different publication? The following table shows where you can get more detailed information when depreciating certain types of property.

For information on depreciating:	See Publication:
A car	463, Travel, Entertainment, Gift, and Car Expenses
Residential rental property	527, Residential Rental Property
Office space in your home	587, Business Use of Your Home (Including Use by Daycare Providers)
Farm property	225, Farmer's Tax Guide

Comments and suggestions. We welcome your comments about this publication and your suggestions for future editions.

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1. Overview of Depreciation

Introduction

Depreciation is an annual income tax deduction that allows you to recover the cost or other basis of certain property over the time you use the property. It is an allowance for the wear and tear, deterioration, or obsolescence of the property.

This chapter discusses the general rules for depreciating property. It explains the following.

- What property can be depreciated.
- What property cannot be depreciated.
- When depreciation begins and ends.
- Whether MACRS can be used to figure depreciation.
- What the basis of property is.
- How to treat improvements.
- When to file Form 4562.
- How to correct depreciation claimed incorrectly in a previous year.

Useful Items

You may want to see:

Publication

❏ **534** Depreciating Property Placed in Service Before 1987

❏ **535** Business Expenses

❏ **538** Accounting Periods and Methods

❏ **551** Basis of Assets

Form (and Instructions)

❏ **Sch C (Form 1040)** Profit or Loss From Business

❏ **Sch C-EZ (Form 1040)** Net Profit From Business

❏ **2106** Employee Business Expenses

❏ **2106-EZ** Unreimbursed Employee Business Expenses

❏ **3115** Application for Change in Accounting Method

❏ **4562** Depreciation and Amortization

See chapter 7 for information about getting publications and forms.

What Property Can Be Depreciated?

Terms you may need to know (see Glossary):

Adjusted basis

Basis

Commuting

Disposition

Fair market value

Intangible property

Listed property

Placed in service

Tangible property

Term interest

Useful life

You can depreciate most types of tangible property (except land), such as buildings, machinery, vehicles, furniture, and equipment. You also can depreciate certain intangible property, such as patents, copyrights, and computer software.

To be depreciable, the property must meet all the following requirements.

- It must be property you own.
- It must be used in your business or income-producing activity.
- It must have a determinable useful life.
- It must be expected to last more than one year.

The following discussions provide information about these requirements.

Property You Own

To claim depreciation, you usually must be the owner of the property. You are considered as owning property even if it is subject to a debt.

Example 1. You made a down payment on rental property and assumed the previous owner's mortgage. You own the property and you can depreciate it.

Example 2. You bought a new van that you will use only for your courier business. You will be making payments on the van over the next 5 years. You own the van and you can depreciate it.

Leased property. You can depreciate leased property only if you retain the incidents of ownership (explained below) in the property. This means you bear the burden of exhaustion of the capital investment in the property. Therefore, if you lease property from someone to use in your trade or business or for the production of income, you generally cannot depreciate its cost because you do not retain the incidents of ownership. You can, however, depreciate any capital improvements you make to the property. See *How Do You Treat Improvements* later in this chapter and *Additions and Improvements* under *Which Recovery Period Applies* in chapter 4.

If you lease property to someone, you generally can depreciate its cost even if the lessee (the person leasing from you) has agreed to preserve, replace, renew, and maintain the property. However, if the lease provides that the lessee is to maintain the property and return to you the same property or its equivalent in value at the expiration of the lease in as good condition and value as when leased, you cannot depreciate the cost of the property.

Incidents of ownership. Incidents of ownership in property include the following.

- The legal title to the property.
- The legal obligation to pay for the property.
- The responsibility to pay maintenance and operating expenses.
- The duty to pay any taxes on the property.
- The risk of loss if the property is destroyed, condemned, or diminished in value through obsolescence or exhaustion.

Life tenant. Generally, if you hold business or investment property as a life tenant, you can depreciate it as if you were the absolute owner of the property. However, see *Certain term interests in property* under *Excepted Property,* later.

Cooperative apartments. If you are a tenant-stockholder in a cooperative housing corporation and use your cooperative apartment in your business or for the production of income, you can depreciate your stock in the corporation, even though the corporation owns the apartment.

Figure your depreciation deduction as follows.

1. Figure the depreciation for all the depreciable real property owned by the corporation. If you bought your cooperative stock after its first offering, figure the depreciable basis of this property as follows.
   a. Multiply your cost per share by the total number of outstanding shares.
   b. Add to the amount figured in (a) any mortgage debt on the property on the date you bought the stock.
   c. Subtract from the amount figured in (b) any mortgage debt that is not for the depreciable real property, such as the part for the land.
2. Subtract from the amount figured in (1) any depreciation for space owned by the corporation that can be rented but cannot be lived in by tenant-stockholders.
3. Divide the number of your shares of stock by the total number of shares outstanding, including any shares held by the corporation.
4. Multiply the result of (2) by the percentage you figured in (3). This is your depreciation on the stock.

Your depreciation deduction for the year cannot be more than the part of your adjusted basis in the stock of the corporation that is allocable to your business or income-producing property.

Example. You figure your share of the cooperative housing corporation's depreciation to be $30,000. Your adjusted basis in the stock of the corporation is $50,000. You use one half of your apartment solely for business purposes. Your depreciation deduction for the stock for the year cannot be more than $25,000 ($^1/_2$ of $50,000).

Change to business use. If you change your cooperative apartment to business use, figure your allowable depreciation as explained earlier. The basis of all the depreciable real property owned by the cooperative housing corporation is the smaller of the following amounts.

- The fair market value of the property on the date you change your apartment to business use. This is considered to be the same as the corporation's adjusted basis minus straight line depreciation, unless this value is unrealistic.
- The corporation's adjusted basis in the property on that date. Do not subtract depreciation when figuring the corporation's adjusted basis.

If you bought the stock after its first offering, the corporation's adjusted basis in the property is the amount figured in (1), above. The fair market value of the property is considered to be the same as the corporation's adjusted basis figured in this way minus straight line depreciation, unless the value is unrealistic.

For a discussion of fair market value and adjusted basis, see Publication 551.

Property Used in Your Business or Income-Producing Activity

To claim depreciation on property, you must use it in your business or income-producing activity. If you use property to produce income (investment use), the income must be taxable. You cannot depreciate property that you use solely for personal activities.

Partial business or investment use. If you use property for business or investment purposes and for personal purposes, you can deduct depreciation based only on the business or investment use. For example, you cannot deduct depreciation on a car used only for commuting, personal shopping trips, family vacations, driving children to and from school, or similar activities.

RECORDS You must keep records showing the business, investment, and personal use of your property. For more information on the records you must keep for listed property, such as a car, see *What Records Must Be Kept* in chapter 5.

CAUTION *Although you can combine business and investment use of property when figuring depreciation deductions, do not treat investment use as qualified business use when determining whether the business-use requirement for listed property is met. For information about qualified business use of listed property, see* What Is the Business-Use Requirement *in chapter 5.*

Office in the home. If you use part of your home as an office, you may be able to deduct depreciation on that part based on its business use. For information about depreciating your home office, see Publication 587.

Inventory. You cannot depreciate inventory because it is not held for use in your business. Inventory is any property you hold primarily for sale to customers in the ordinary course of your business.

If you are a rent-to-own dealer, you may be able to depreciate certain property held in your business. See *Rent-to-own dealer* under *Which Property Class Applies Under GDS* in chapter 4.

In some cases, it is not clear whether property is held for sale (inventory) or for use in your business. If it is unclear, examine carefully all the facts in the operation of the particular business. The following example shows how a careful examination of the facts in two similar situations results in different conclusions.

Example. Maple Corporation is in the business of leasing cars. At the end of their useful lives, when the cars are no longer profitable to lease, Maple sells them. Maple does not have a showroom, used car lot, or individuals to sell the cars. Instead, it sells them through wholesalers or by similar arrangements in which a dealer's profit is not intended or considered. Maple can depreciate the leased cars because the cars are not held primarily for sale to customers in the ordinary course of business, but are leased.

If Maple buys cars at wholesale prices, leases them for a short time, and then sells them at retail prices or in sales in which a dealer's profit is intended, the cars are treated as inventory and are not depreciable property. In this situation, the cars are held primarily for sale to customers in the ordinary course of business.

Containers. Generally, containers for the products you sell are part of inventory and you cannot depreciate them. However, you can depreciate containers used to ship your products if they have a life longer than one year and meet the following requirements.

- They qualify as property used in your business.
- Title to the containers does not pass to the buyer.

To determine if these requirements are met, consider the following questions.

- Does your sales contract, sales invoice, or other type of order acknowledgment indicate whether you have retained title?
- Does your invoice treat the containers as separate items?
- Do any of your records state your basis in the containers?

Property Having a Determinable Useful Life

To be depreciable, your property must have a determinable useful life. This means that it must be something that wears out, decays, gets used up, becomes obsolete, or loses its value from natural causes.

Property Lasting More Than One Year

To be depreciable, property must have a useful life that extends substantially beyond the year you place it in service.

Example. You maintain a library for use in your profession. You can depreciate it. However, if you buy technical books, journals, or information services for use in your business that have a useful life of one year or less, you cannot depreciate them. Instead, you deduct their cost as a business expense.

What Property Cannot Be Depreciated?

Terms you may need to know (see Glossary):

Amortization

Basis

Goodwill

Intangible property

Remainder interest

Term interest

Certain property cannot be depreciated. This includes the following.

Land

You cannot depreciate the cost of land because land does not wear out, become obsolete, or get used up. The cost of

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