

# The Form 4562 Explained

## Depreciation & Amortization Overview

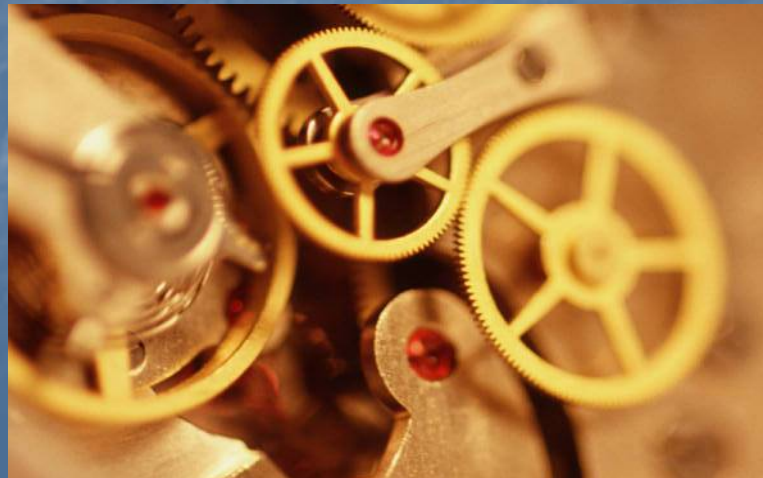
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# Definitions and Concepts

# Depreciation Defined

- According to the IRS, "Depreciation is the yearly deduction allowed to recover the cost, or other basis, of business or investment property having a useful life substantially beyond the tax year. However, land is not depreciable."

In essence, as a benefit to the purchaser, the cost of the asset is deducted from taxable income via a series of yearly expenses.



# Depreciation Begins When...

- The asset is first used in your business

Or

- The asset is first used for the production of income

# Depreciation Ends When...

- The asset is taken out of service

Or

- The cost of the asset has been fully recovered (fully depreciated); the depreciable cost of the asset – the asset's salvage value = the sum of all depreciation expenses taken throughout the years (recorded in an account called Accumulated Depreciation).

Or

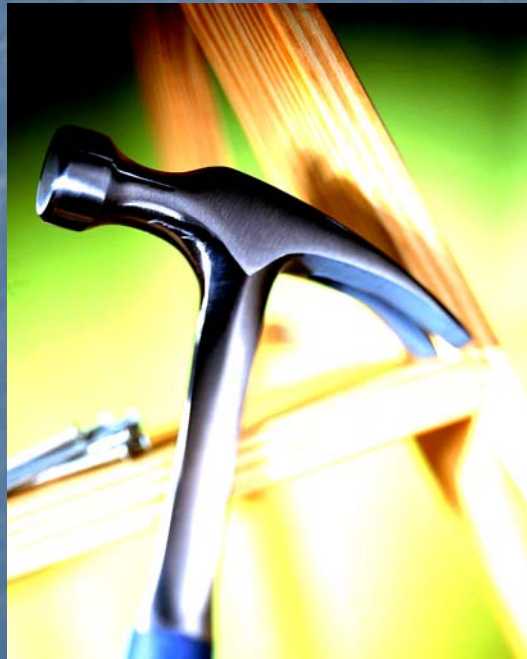
- The asset is no longer used in either your business, or for the production of income.

# Depreciation: Tax vs. Book Method

- Depreciation may be calculated using different methods for tax reporting and for book records.
- For Tax reporting, the IRS requires assets to be depreciated under one of two methods, ACRS or MACRS (both explained below). Each method has classification categories which stipulate the useful lives of specific types of assets. Yearly Depreciation expense is then calculated using the appropriate useful life.
  - According to the 1986 Tax Reform Act, assets placed into service after December 31, 1981 but before December 31, 1986 are depreciated under the Accelerated Cost Recovery System (ACRS) and assets placed into service after December 31, 1986 are depreciated using the Modified Accelerated Cost Recovery System (MACRS).
- For book purposes, however, depreciation may be calculated using a variety of methods:
  - Straight-line
  - Declining balance
  - Sum of the years digits
  - Units of Production / Rate of Use



# Amortization



# Amortization Is...

- The decline in useful life of an intangible asset
  - Because the asset is intangible, there is no tangible/physical wear and tear, so the asset cannot be depreciated
- Derived from the Italian, "Amortia" – little death
  - Amortization is the "little death" of an intangible asset
- Like depreciation, amortization recovers certain costs of an asset over a fixed period of time.

# Candidates for Amortization

- The costs of starting a business
- Goodwill
- Certain Landscaping Costs
- Patents
- Intellectual Property
- Some Software
- Pollution Control Facilities (limited for corporations)
- Certain Bond Premiums
- Research and Experimental Expenditures
- **The Cost of Acquiring a Lease**
- Qualified Forestation and Reforestation Costs
- Qualified Building Revitalization Expenditures (with certain criteria)
- Organizational Expenditures for a Corporation or Partnership
- Going Concern Value
- Workforce in Place
- Business books and records, operating systems, or any other information base

# Candidates for Amortization (cont'd)

- Any Patent, Copyright, Formula, Process, Design, Pattern, Know-how, Format, or Similar Item
- Any Customer-Based Intangible (e.g. composition of market or market share)
- Any Supplier-Based Intangible
- Any License, Permit, or Other Right Granted by a Governmental Unit
- Any Covenant Not to Compete Entered Into In Connection with The Acquisition of a Business
- Any Franchise (other than a sports franchise), Trademark, or Trade Name

# Amortizable Business Start-Up Expenditures

- **In order to elect to amortize start-up expenditures, attach a statement to your income tax return that provides:**
  1. A detailed description of the trade or business
  2. The month in which the active trade or business began (or was acquired)
  3. The number of months in the amortization period you are selecting cannot be less than 60)
  4. A description of each start-up expenditure incurred (whether or not paid)

# Listed Property

- Listed property generally includes:
  - Passenger automobiles weighing 6,000 lbs or less
  - Any other property used for transportation if the nature of the property lends itself to personal use, such as motorcycles, pick-up trucks, etc.
  - Any property used for entertainment or recreational purposes (such as photographic, phonographic, communication, and video recording equipment)
  - Cellular telephones (or other similar telecommunications equipment)
  - Computers or Peripheral Equipment
  - A portion of the taxpayer's home is treated as a regular business establishment only if that portion meets the requirements under section 280A (c) (1) for deducting expenses attributable to the business use of a home. However, for any property listed in 1 above, the regular business establishment of an employee is his or her employer's regular business establishment.

# Listed Property Exceptions

- Listed Property **excludes**:
  - Photographic, phonographic, communication, or video equipment **used exclusively** in a taxpayer's trade or business or at the taxpayer's regular business establishment
  - Any computer or peripheral equipment used exclusively at a regular business establishment and owned or leased by the person operating the establishment
  - An ambulance, hearse, or vehicle used for transporting **persons or property** for hire.

# Commuting

- Commuting, generally, is travel between your home and a work location. However, travel that meets ANY of the following conditions is not commuting:
  - You have at least one regular work location away from your home and the travel is to a temporary work location in the same trade or business, regardless of the distance. Generally, a temporary work location is one where your employment is expected to last 1 year or less. See Pub. 463 for details.
  - The travel is to a temporary work location outside the metropolitan area where you live and normally work
  - Your home is your principal place of business under section 280A(c)(1)(A) (for purposes of deducting expenses for business use of your home) and the travel is to another work location in the same trade or business, regardless of whether that location is regular or temporary and regardless of distance.

# Part I of Form 4562

Election to Expense Certain Tangible Property  
Under Section 179

# Section 179 Property

- Form 4562 allows an expense for a classification of property known as Section 179 Property. This property includes tangible purchased property, depreciable under MACRS (see previous slide). Section 179 Property can be:
  - Personal Property
  - A single purpose agricultural or horticultural structure
  - Certain other property (See section 1245 (a)(3))
- Section 179 Property does not include:
  - Property held for investment (section 212 property)
  - Property used mainly outside of the United States (unless otherwise stated in section 168 (g)(4))
  - Property used mainly to furnish lodging or in connection with the furnishing of lodging (except that listed in section 50(b)(2))
  - Property used by a tax exempt organization (other than a section 521 farmers' cooperative) unless the property is used mainly in a taxable unrelated trade or business.
  - Property used by a governmental unit or foreign person or entity (except for property used under a lease with a term of less than 6 months).
  - Air conditioning or heating units

# Election for Section 179 Expense

- Section 179 Property may be then deducted under Section 179 Expense.
  - This is an election to expense part or **all** (a lump deduction) of the cost of Section 179 property that you placed in service during the tax year and used predominantly (more than 50%) in your trade or business.
  - If you elect to expense Section 179 Property, you must reduce the amount on which you figure your depreciation or amortization deduction by the section 179 expense amount.
  - Once this Section 179 deduction has been taken, it may not be changed without IRS consent.
  - The total amount of your Section 179 Expense may not be greater than the IRS-governed amount, stated on line 1 (e.g. \$24,000 in 2001).
  - Your Section 179 Expense for the year also may not exceed your business income
- The maximum amount allowed to be deducted under Section 179 by the IRS will continue to increase, yearly, through 2003.

# Part I, Line 11

- The Section 179 Expense deduction is limited by the “business income” limitation under section 179 (b)(3).
- You are considered to **actively conduct** a trade or business only if you meaningfully participate in its management or operations. A mere passive investor is not considered to actively conduct a trade or business.

# Part II of Form 4562

MACRS Depreciation for Assets Placed in  
Service Only During Your 2001 Tax Year

# What you need to know about Part II

- The Modified Accelerated Cost Recovery System includes the General Depreciation System (GDS) and the Alternative Depreciation System (ADS).
  - Depreciation may be an adjustment for alternative minimum tax purposes.
- Generally MACRS is used to depreciate any tangible property placed in service after 1986.
- MACRS does not apply to films, videotapes, and sound recordings.

# Section B, Lines 15a – 15i: GDS Property Classification

- Lines 15a - 15i are only for assets placed in service **during** the tax year beginning in 2001 and depreciated under the General Depreciation System, except for automobiles and other listed property, which are reported in Part V.
  - 3-year Property:
    - A race horse that is more than 2 years old at the time it is placed in service.
    - Any horse (other than a race horse ) that is more than 12 years old at the time it is placed in service.
    - Any qualified rent-to-own property (as defined in section 168(i)(14)).
  - 5-year Property:
    - Automobiles
    - Light general purpose trucks.
    - Typewriters, calculators, copiers, and duplicating equipment
    - Any section 1245 property used in connection with research and experimentation
    - Certain energy property specified in section 168(e)(3)(B)(vi).
    - Appliances, **carpets**, furniture, etc., used in a rental real estate activity.
  - 7-year Property:
    - Office furniture and equipment
    - Railroad track
    - Any property that does not have a class life and is not otherwise classified.

# Section B, Lines 15a – 15i: GDS Property Classification (cont'd)

- 10-year Property
  - Vessels, barges, tugs, and similar water transportation equipment.
  - Any single purpose agricultural or horticultural structure (see section 168(i)(13)).
  - Any tree or vine bearing fruit or nuts.
  
- Residential rental property is a building in which 80% or more of the total rent is from dwelling units.
  
- Nonresidential real property is any real property that is neither residential rental property nor property with a class life of less than 27.5 years

# Section B, Lines 15a – 15i: GDS Property Classification (cont'd)

- Residential Rental Property is a building in which 80% or more of the total rent is from dwelling units.



# Section B, Lines 15a – 15i: GDS Property Classification (cont'd)

- Nonresidential Real Property is any real property that is neither residential rental property nor property with a class life of less than 27.5 years



# Section B – Recovery Period for Most Property

Classification	Recovery Period / Useful Life
3-year Property	3 years
5-year Property	5 years
7-year Property	7 years
10-year Property	10 years
15-year Property	15 years
20-year Property	20 years
25-year Property	25 years
Residential rental property	27.5 years
Nonresidential real property	39 years
Railroad gradings and tunnel bores	50 years

# Section B, Column (e) – Applicable Convention for Determining Depreciation

- The applicable **convention** determines the portion of the tax year for which depreciation is allowable during a year property is either placed in service or disposed of. There are three types of conventions. Selecting the correct convention requires that you must know the type of property being depreciated and when you placed the property in service.
  - Mid-Quarter Convention:
    - If the total depreciable bases of MACRS property placed in service during the last 3 months of your tax year exceed 40% of the total depreciable bases of MACRS property placed in service during the entire tax year, the mid-quarter convention generally applies. However, certain taxpayers may elect out of the mid-quarter convention. If this convention is used, the acronym “MQ” is placed in the appropriate column (column e).
  - Half-Year Convention:
    - This convention applies to all property reported on lines 15a through 15g, unless the mid-quarter convention applies. It does not apply to residential rental property, nonresidential real property, and railroad gradings and tunnel bores. It treats all property placed in service (or disposed of) during any tax year as placed in service (or disposed of) on the midpoint of that tax year. If this convention is used, the acronym “HY” is placed in the appropriate column (column e).
  - Mid-Month Convention
    - This convention applies **only** to residential rental property, nonresidential real property (lines 15h or 15i), and railroad gradings and tunnel bores. It treats all property placed in service (or disposed of) during any month as placed in service (or disposed of) on the midpoint of that month. If this convention is used, the acronym “MM” is placed in the appropriate column (column e).

# Section C – Alternative Depreciation System (ADS)

- Lines 16a through 16c on form 4562 are for assets, other than automobiles, and other listed property, placed in service **only** during the tax year beginning in 2001 and depreciated under the Alternative Depreciation System (ADS). The depreciation on assets placed in service in prior years is placed on line 17.
- Property that **must** be depreciated under ADS includes:
  - Tangible property used predominantly outside the United States
  - Tax-exempt use property
  - Tax-exempt bond financed property
  - Imported property covered by an executive order of the President of the United States.
  - Property used predominantly in a farming business and placed in service during any tax year in which you made an election under section 263A(d)(3).

# Part V of Form 4562

Listed Property

# Part V – Listed Property

- If you claim the standard mileage rate, actual vehicle expenses (including depreciation), or depreciation on other listed property, you must provide the information requested in Part V, regardless of the tax year the property was placed in service.

# Column (d)

- If you converted the property from personal use to business/investment use, your basis for depreciation is the **smaller** of the property's adjusted basis or its fair market value on the date of conversion.

# Column (h)

- Limits for passenger automobiles:
  - The depreciation deduction plus section 179 expense deduction for passenger automobiles is limited for any tax year
- Definitions:
  - “Passenger automobiles” are 4-wheeled vehicles manufactured primarily for use on public roads that are rated at 6,000 lbs unloaded gross vehicle weight or less. For a truck or van, gross vehicle weight is substituted for unloaded gross vehicle weight. “Electric passenger automobiles” are vehicles produced by an original equipment manufacturer and designed to run primarily on electricity.
- Exception:
  - The following vehicles are not considered passenger automobiles:
    - An ambulance, hearse, or combination ambulance-hearse used in your trade or business.
    - A vehicle used in your trade or business of transporting persons or property for compensation or hire.

# Column (h) – Limits for Passenger Automobiles Placed in Service After 1998

IF you placed your automobile in service:	AND the number of tax years in which this automobile has been in service is:	THEN the limit of your depreciation and section 179 expense deduction is*:
Jan. 1 – Dec. 31, 1999	3	\$2,950
	4	\$1,775
Jan. 1 – Dec. 31, 2000	2	\$4,900
	3	\$2,950
Jan. 1 – Dec. 31, 2001	1	\$3,060
	2	\$4,900
After Dec. 31, 2001	1	**

\*For vehicles placed in service after August 5, 1997, this limit does not apply to the cost of any qualified clean-fuel vehicle property (such as retrofit parts and components) installed on a vehicle for the purpose of permitting that vehicle to run on a clean-burning fuel. See section 179A for definitions.

\*\*The limit for automobiles placed in service after Dec. 31, 2001, will be published in the Internal Revenue Bulletin. This amount was not available at the time these instructions were prepared.

# Section C – Questions for Employers Who Provide Vehicles for Use by Their Employees

- For employers providing vehicles to their employees, two types of written policy statements will satisfy the employer's substantiation requirements under section 274 (d):
  1. A policy statement that prohibits personal use including commuting
  2. A policy statement that prohibits personal use except for commuting
  
- An employee does not need to keep a separate set of records for any vehicle that satisfies these written policy statement rules.

# Line 36

- A policy statement that prohibits personal use (except for commuting) is **not** available if the commuting employee is an officer, director, or 1% or more owner. This policy must meet **all** of the following conditions.
  - The employer owns or leases the vehicle and provides it to one or more employees for use in the employer's trade or business, and it is used in the employer's trade or business.
  - For bona fide non-compensatory business reasons, the employer requires the employee to commute to and/or from work in the vehicle.
  - The employer establishes a written policy under which the employee may not use the vehicle for personal purposes, other than commuting or de minimis personal use (e.g., a stop for a personal errand between a business delivery and the employee's home).
  - Except for de minimis use, the employer reasonably believes that the employee does not use the vehicle for any personal purpose other than commuting.
  - The employer accounts for the commuting use by including an appropriate amount in the employee's gross income.
  
- There must be evidence that would enable the IRS to determine whether use of the vehicle meets the conditions stated above.

# Line 40, Column (a)

- Describe the costs you are amortizing. You may amortize the following:
  - Pollution control facilities (section 169, limited by section 291 for corporations)
  - Certain bond premiums (section 171)
  - Research and experimental expenditures (section 174)
  - **The cost of acquiring a lease** (section 178)
  - Qualified forestation and reforestation costs (section 194). See Pub. 535 for limitations. Partnerships and S corporations, see the line 42 instructions on page 9.
  - Qualified revitalization expenditures (section 1400I). These are certain capital expenditures that relate to a qualified revitalization building located in an area designated as a renewal community.
  - Organizational expenditures for a corporation (section 248) or partnership (section 709).
  - Optional write-off of certain tax preferences over the period specified in section 59(e).

# Line 40, Column (a) – (cont'd)

- Certain section 197 intangibles (which must be amortized over 15 years starting with the month the intangibles were acquired), including:
  1. Goodwill
  2. Going concern value
  3. Workforce in place
  4. Business books and records, operating systems, or any other information base
  5. Any patent, copyright, formula, process, design, pattern, knowhow, format, or similar item
  6. Any customer-based intangible
  7. Any license, permit, or other right granted by a governmental unit
  8. Any covenant not to compete entered into in connection with the acquisition of a business
  9. Any franchise (other than a sports franchise), trademark, or trade name.
  
- Business start-up expenditures (section 195). To elect to amortize start-up expenditures, attach a statement to your income tax return that provides:
  1. A detailed description of the trade or business
  2. The month in which the active trade or business began (or was acquired)
  3. The number of months in the amortization period you are selecting (cannot be less than 60)
  4. A description of each start-up expenditure incurred (whether or not paid).