What property can I depreciate?

Objectives

After completing this lesson, you should be able to:

- Define *depreciation*.
- Determine whether the taxpayer meets the requirements to depreciate an asset.
- List the types of excepted property.

This course covers the basics of depreciation, including what property you can depreciate and how to depreciate property. A second course, *Intermediate Depreciation*, covers specific situations and how to depreciate property in those situations.

Depreciate or deduct

Every business owner buys property to assist them in running a business, or property that is the main purpose of the business. For example, if the taxpayer is a sole proprietor, you might purchase pens and paper for your office, desks, and perhaps a copier or printer. You can deduct the cost of most of these items on the taxpayer's business tax return, such as one of the following:

- Schedule C
- Schedule E
- Form 1120
- Form 1120S
- Another business tax return

If the taxpayer expects the property they bought to last over a year, deduct it over the course of time the taxpayer expects the property to last. This allows the taxpayer to deduct the expenses for wear and tear over the life of the property rather than all in one year.

To decide whether the property should be depreciated or deducted fully in the first year of use, there are several factors to consider. Answer the following questions:

- Does the taxpayer own the property?
- Is the property used in the business or held to produce income?
- Does the property have a useful life that extends substantially beyond the year it is placed in service?
- Does the property have a determinable useful life?
- Is the property excepted property?

The answers to these questions determine whether the taxpayer should depreciate the property. This section helps you to determine the answers to each of these questions and whether to depreciate property on the tax return.

Ownership

The first question is:

Does the taxpayer own the property?

The answer to this question is simple: if the taxpayer owns the property outright, the property is owned. This does not include rented or leased property. If the taxpayer rents or leases the property, you cannot depreciate it, even if the property is otherwise depreciable. The taxpayer may be able to depreciate capital improvements. Capital improvements are covered later in this course.

The taxpayer does not have to own the property completely. If it is theirs, but secured by a debt, the taxpayer is still the owner of the property.

In order for the taxpayer to own the property, consider the following:

- The taxpayer must hold legal title to the property.
- The taxpayer must have a legal obligation to pay for the property.
- The taxpayer must have the responsibility to pay for maintenance and operating expenses for the property.
- The taxpayer must have the duty to pay taxes, if any, on the property.
- The taxpayer must have the risk of loss if the property is destroyed or otherwise unusable.

Business or income use

The second question is:

Is the property used in the business or held to produce income?

This question basically determines the taxpayer's purpose in purchasing the property. If the property is purchased to resell, the taxpayer cannot depreciate it. If it is purchased to resell, it is part of the business's inventory.

If the taxpayer purchased the property to use in a business, it may be depreciable depending on the answers to the other questions. This applies whether the property actually produces income or if it is used in producing income.

For example, the taxpayer may have a rental property. The actual property may be depreciable, because the rent received from that property is income. If the taxpayer uses a printer to print rent statements for customers, that printer may also be depreciable.

Useful life beyond year placed in service

The third question is:

Does the property have a useful life that extends substantially beyond the year it is placed in service?

To answer this question, determine how long the taxpayer expects to use the property. If the taxpayer purchases pens or pencils, or some other property that is used quickly, you cannot depreciate that property. The taxpayer can claim that property as a business expense in the year it is purchased. If, however, the property will last longer than a year, such as a computer, printer, telephone, or other such property, it has a useful life beyond the first year.

Determinable useful life

The fourth question is:

Does the property have a determinable useful life?

To determine whether the property has a determinable useful life, consider whether it wears out, decays, becomes obsolete, etc. For example, you cannot depreciate land because it does not wear out or lose its value. You can, however, depreciate a building because buildings decay and can only be expected to last for a certain amount of time.

Excepted property

The fifth, and last, question is:

Is the property excepted property?

Certain types of property are considered *excepted property*. This term means that the property is excepted from being depreciable; you can never depreciate it, regardless of the circumstances.

Excepted property includes the following:

- Land
- Property that the taxpayer places in service and disposes of within the same year
- Equipment that the taxpayer uses to build capital improvements
- Section 197 intangibles
- Certain term interests

Section 197 intangibles

Section 197 intangibles are any intangible assets that are discussed in Internal Revenue Code section 197. You cannot depreciate these assets. Instead, amortize them over 15 years, or 180 months. The following are examples of section 197 intangibles:

- Goodwill
- Going concern value
- Workforce in place
- Business books and records, operating systems, or other information bases
- Patent, copyright, formula, process, design, pattern, know-how, format, or similar items
- Computer-based intangibles
- Supplier-based intangibles
- Any similar item
- Franchise trademarks or trade names

For more information on Section 197 intangible property, see one of the following:

- IRC section 197
- IRS Publication 535, B*usiness Expenses*

Summary

You should now be able to:

- Define *depreciation*.
- Determine whether the taxpayer meets the requirements to depreciate an asset.
- List the types of excepted property.