

# Cost Recovery Tax Info Sheet (2010)

## CAPITAL VS. DEDUCTIBLE EXPENSES

It is not always clear whether an expenditure to repair or refurbish property is a capital item or a currently deductible repair. Capital expenditures must be added to the property's tax basis and recovered through depreciation. For property not subject to depreciation, amortization or depletion, capitalized costs are only recovered when the property is disposed. Incidental repairs are not capital expenditures and thus can be deducted in the current year.

**Capital expenditures.** These include (1) costs for new buildings or permanent improvements or betterments to increase the value of the property or (2) amounts expended in restoring property or making good the exhaustion from depreciation.

**Capital expenditures include amounts paid or incurred that:**

- 1) Prolong an asset's life,
- 2) Substantially increase its value or
- 3) Make it suitable for a different use.

Examples of capital expenditures include the cost of defending or perfecting title to property, architects' fees, purchase commissions paid to a broker and goodwill connected to acquiring the assets of a going concern.

**Incidental repairs.** These are a current deduction as ordinary and necessary business expenses, provided the repair does not materially add to the value of property or appreciably prolong its life. Rather, repairs keep the property in an ordinarily efficient operating condition.

**Examples of deductible repairs include:**

- Reconditioning floors (but not replacement),
- Repainting interior and exterior walls,
- Cleaning and repairing roofs and gutters and
- Fixing plumbing leaks (but not replacement of fixtures).

Costs of acquiring property are generally capitalized as part of the property's basis. However, expenses for repairs immediately after the property is acquired do not have to be capitalized if the expense would ordinarily qualify for deduction as a repair. If the repairs are required as a condition of the purchase, the cost is capitalized.

**Caution:** Repairs that are part of a general plan of rehabilitation, improvement, alteration or modernization must be capitalized even though, taken separately, they would be deductible.

## DEPRECIATING PROPERTY OVER THE CORRECT LIFE

Depreciable property placed in service after 1986 is generally subject to MACRS depreciation. All MACRS property falls into one of the following recovery periods:

MACRS Recovery Period—2010 Additions	
Recovery Period	Examples of Assets Included in the Class
3 year	Race horses, other horses over 12 years old, qualified rent-to-own property and tractor units for over-the-road use.
5 year	Automobiles, light general purpose trucks, most computers, high technology medical equipment, office machinery, breeding and dairy cattle.
7 year	Furniture and office equipment that is not in the five-year class (such as desks, files and safes); tangible personal property not in other classes.

*Table continued in the next column*

## MACRS Recovery Period—2010 Additions (Continued)

Recovery Period	Examples of Assets Included in the Class
10 year	Single-purpose agricultural or horticultural structures, any tree or vine bearing fruit or nuts and certain qualified smart electric property.
15 year	Land improvements and retail motor fuels outlets.
20 year	Certain farm buildings, municipal sewers and electric utility land improvements.
25 year	Certain water utility property.
27.5 year	Residential rental property.
39 year	Nonresidential real property.
50 year	Railroad grading or tunnel bone.

**Segregate assets for tax.** For financial reporting, assets are often grouped together as "equipment" or "furniture and fixtures." For tax purposes, a seven-year recovery period would be assigned. However, "equipment" could include computers or high technology medical equipment that should be assigned a five-year recovery period.

## SECTION 179 DEDUCTION AND SPECIAL DEPRECIATION ALLOWANCE

**Section 179 deduction.** For tax years beginning in 2010, taxpayers can claim a Section 179 deduction (immediately expense) up to \$250,000. If investment in Section 179 property exceeds \$800,000 for 2010, the maximum deduction of \$250,000 is reduced dollar-for-dollar by the excess. Therefore, for 2010, the allowable deduction is completely phased out if investment in Section 179 property reaches \$1,050,000 or more.

**Lost Section 179 deductions.** There is no carryover of deductions that are lost because of the investment limit or the maximum deduction limit. This means that a taxpayer with Section 179 deductions passing through from partnerships or S corporations may lose some or all of the deductions. In this case, even if a deduction is reduced or eliminated, the taxpayer must still reduce his basis by the nondeductible Section 179 expense.

**Special depreciation allowance.** The special depreciation allowance is not available for assets placed in service after 2009 (2010 for certain property with longer production periods, transportation property and aircraft) [IRC §168(k)(2)]. However, Congress has extended the special depreciation allowance in the past and it is possible that the provision may be extended or enacted again.

**Benefits of claiming a Section 179 deduction:**

- May avoid the short year depreciation rules.
- Amounts allowed as a deduction under Section 179 are not subject to the Section 263A uniform capitalization (UNICAP) rules.
- The basis of property expensed under Section 179 is excluded when applying the 40% test to determine if the mid-quarter convention applies. Thus, the Section 179 election can be used to avoid or trigger the mid-quarter convention rules to create the desired tax result.
- The Section 179 deduction is allowed for computing alternative minimum tax.