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WASHINGTON — The Internal Revenue Service encourages taxpayers to understand the rules surrounding depreciation before attempting to deduct business-related depreciation expenses.

Overstated adjustments, deductions, exemptions and credits comprise up to $30 billion per year in unpaid taxes, according to IRS estimates. In order to educate taxpayers regarding their filing obligations, this fact sheet, the sixth in a series, explains the general rules for depreciating assets.

Depreciation Basics

In general, if property is acquired for use in a business or another income-producing activity and is expected to last more than one year, taxpayers cannot deduct the entire cost as a business expense in the year it was acquired. They must depreciate the cost over the property's useful life (as defined by the Internal Revenue Code) and deduct part of the cost each year on the Form 4562, Depreciation and Amortization. (Refer to IRC Section 179 Deduction below for an exception.)

Correctly computing depreciation deductions can be a challenging process which cannot be covered thoroughly in this fact sheet. Taxpayers with depreciable business or income-producing assets should study the resources listed at the end of this article and consider using the services of tax professionals when appropriate.

In order to be depreciated, property must:

- Be property the taxpayer owns
- Be used in the taxpayer's business or income-producing (investment) activity
- Have a determinable useful life
- Be expected to last more than one year

Certain property cannot be depreciated, including:

- Land
- Property placed in service and disposed of in the same year
- Certain types of intangible assets, such as franchises, agreements not to compete, and goodwill

Property used only for personal activities cannot be depreciated. If an asset such as a home or motor vehicle has both personal and business use, only the business portion of its cost may be depreciated. Depreciation rules regarding partial business or investment use are discussed in Publication 946, How to Depreciate Property.

Computing Depreciation

In order to compute depreciation correctly a taxpayer must know the following:

- When the asset was "placed in service" for use in a business or income-producing activity
- The basis of the depreciable asset, and
- The depreciation methods available

Generally property is considered placed in service when it is ready and available for a specific use, regardless of whether or not it is actually used at the time. For example, a house purchased for use as rental property is placed in service when it is ready and available to rent, even if it is not actually rented at that time.

The basis is the amount that will be recovered (deducted) once the asset is fully depreciated. It may be the cost of the asset or another amount, depending on how and when it was acquired. Information on determining basis is available in Publication 946, How to Depreciate Property, and Publication 551, Basis of Assets.

Most assets are depreciated according to the Modified Accelerated Cost Recovery System. However, there are situations when MACRS cannot be used. Taxpayers should carefully study the information in Publication 946 to be certain they are using the correct method.

IRC Section 179 Deduction

Some taxpayers can elect to recover all or part of the cost of certain qualifying property, up to a certain dollar limit each year, by claiming a Section 179 deduction. By taking the Section 179 deduction a taxpayer chooses to deduct depreciation up front rather than over the life of the asset. It is especially important to remember that the Section 179 deduction may be taken only on assets acquired for use in trade or business, not on property used for other income-producing activities, such as rental activities. See Publication 946, How to Depreciate Property, for detailed rules applicable to the Section 179 deduction.

Disposing of Depreciable Assets

Depreciation reduces the owner's basis in the property. When depreciable property is sold or disposed of, depreciation that was allowed or allowable on that property must be taken into consideration. In other words, even if no depreciation deduction was taken, the net profit or loss on the disposition of the property must be computed as if depreciation was actually taken. Taxpayers must also follow recapture rules to determine the amount of gain to be treated as ordinary income rather than capital gain. More information on the disposition of assets can be found in Publication 544, Sales and Other Dispositions of Assets.