Individual Income Taxation:
An Application Approach

Update – Spring 2015

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Chapter 6. Loans and Cancellation of Debt

The exception for qualified a qualified principal residence does not apply to forgiveness of a mortgage after December 31, 2013. Accordingly, delete Section **C.4 Qualified Principal Residence Indebtedness** *(page 50).*

Chapter 12. Damages

Treas. Reg. § 1.104-1(c) has been amended to conform to the changes made by the Small Business Job Protection Act of 1996. The regulation no longer defines an injury as one based on "tort or tort-type rights" and now follows the statute, requiring that damages be received on account of a personal physical injury or physical sickness. The injury need not be defined as a tort.

Chapter 25. Depreciation and Amortization

Effective January 1, 2014, the amount of bonus depreciation has been reduced to $25,000. And the amount of the third limitation (the phase out) has been reduced to $200,000. The availability of bonus depreciation for qualified real property has also expired. Accordingly:

- *Replace Section B.5. Bonus Depreciation (pages 215–218).*
- *Replace Examples 4-7 (pages 219–221)*
- *Replace Problems 2-5 (pages 221–222).*

The additional bonus depreciation that had been available under Section 168(k) (referred to in the Tell Me More box on page 216) effectively expired December 31, 2013.

5. Bonus Depreciation

In certain situations a taxpayer may elect to claim bonus depreciation.[1] Bonus depreciation does not mean the taxpayer is entitled to depreciation totaling an amount greater than what he paid for the property. Rather, it means that the taxpayer may claim more depreciation in the year he places the asset in service (and, therefore, less in later years).

Bonus depreciation is one area of the Code that has seen many changes over the years. Thus, it is important to make sure you have read the most recent version of Section 179 before giving advice to a client.

Tell Me More:

On many occasions Congress has implemented additional bonus-type depreciation provisions, allowing the taxpayer to claim additional amounts of depreciation in the first year the property is placed in service (with corresponding less depreciation in the following years). These provisions often are available only for a limited amount of time, operating as an incentive for the taxpayers to utilize them before they expire. See, for example, the now-expired Section 168(k). If the taxpayer is interested in maximizing depreciation deductions in the year the property is placed in service, it is worth reviewing Section 168 for additional, temporary provisions allowing such additional depreciation.

Applicable property. If the taxpayer has placed tangible personal property depreciated using MACRS into service during the taxable year, he may elect to claim bonus depreciation.[2]

Impact of making election. If the taxpayer elects to claim bonus depreciation, he may claim up to $25,000 of depreciation in the year he places the asset in service.[3] The

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[1] Section 179(a). Note that bonus depreciation is not available for property purchased for an investment activity. Depreciation of investment property is discussed in Chapter 29.
[2] Section 179(d)(1).
[3] Section 179(b)(1)(D).

remainder of the cost of the property is recovered under the usual depreciation method. Note this means that in the first year the taxpayer can claim both bonus depreciation and regular (MACRS) depreciation.

Limitations on amount of bonus depreciation. There are three applicable limitations on the amount of bonus depreciation that can be claimed. The first limitation is that the amount of bonus depreciation claimed cannot exceed the cost of the property.[4]

Example. The taxpayer purchased an oven for $5,000 and elected to claim bonus depreciation. The most bonus depreciation he can claim is $5,000. Note that, after claiming the bonus depreciation, he has recovered his entire basis in the oven (his adjusted basis is zero) and he is not entitled to any additional depreciation.

The second limitation is that the amount of bonus depreciation claimed cannot exceed the taxable income derived from the business (before considering any bonus depreciation).[5]

Example. Taxpayer purchased a piece of equipment for $100,000 and elected to claim bonus depreciation. The taxable income from his business is $20,000. The most bonus depreciation he can claim is $20,000. After claiming $20,000 of bonus depreciation, the remaining $80,000 ($100,000 less $20,000 of bonus depreciation) can be recovered using his regular depreciation method.

The third limitation is that, for every dollar over $200,000 that the taxpayer spends on tangible personal property, he must reduce the amount of bonus depreciation he can claim.[6]

Example. Taxpayer purchased a total of $215,000 of tangible personal property. Because the cost of the purchased tangible personal property exceeds $200,000 by $15,000, he must reduce the amount of bonus depreciation by that amount. Thus, the taxpayer can claim $10,000 ($25,000–$15,000) of bonus depreciation.

Examples:		
Amount Spent on Tangible Personal Property	**Amount spent over $200,000**	**Amount of Allowable Bonus Depreciation**
$205,000	$ 5,000	$20,000
$210,000	10,000	15,000
$215,000	15,000	10,000
$225,000	25,000	-0-

Example. Bob purchased a piece of equipment for $125,000. He will use the equipment in his business and the equipment has a five year class life. It is the only

[4] Section 179.
[5] Section 179(b)(3).
[6] Section 179(b)(2)(D).

tangible personal property he purchased that year and his business had taxable income of $300,000. He elected bonus depreciation.

None of the three limitations apply and Bob can claim $25,000 of bonus depreciation. Bob recovers the remaining $100,000 cost of his property ($125,000 cost, less $25,000 bonus depreciation) using his regular depreciation method.

Year	**Calculation**	**Depreciation**	**Adjusted Basis**
1	Bonus	$ 25,000	100,000
1	$100,000 x 20%	20,000	80,000
2	100,000 x 32%	32,000	48,000
3	100,000 x 19.2%	19,200	28,800
4	100,000 x 11.52%	11,520	17,280
5	100,000 x 11.52%	11,520	5,760
6	100,000 x 5.76%	5,760	-0-
		$125,000	

Note that in the first year Bob's total amount of depreciation was equal to the bonus depreciation plus the regular depreciation. Thus, Bob claimed $45,000 of depreciation in that year.

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C. Application of Rules

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Example 4. **Tangible personal property and bonus depreciation.** Arlie owns and operates a soda shop. She purchased for use in her business a new piece of equipment (5-year property) for $200,000 and elected bonus depreciation. It was the only tangible personal property she purchased that year, and her business had taxable income of $300,000.

None of the three limitations apply, and Arlie can claim $25,000 of bonus depreciation in the first year. Arlie recovers the remaining $175,000 cost of her property ($200,000 cost, less $25,000 of bonus depreciation) using her regular depreciation method.

Year	Calculation	Depreciation
1	Bonus	$ 25,000
1	$175,000 x 20%	35,000
2	175,000 x 32%	56,000
3	175,000 x 19.2%	33,600
4	175,000 x 11.52%	20,160
5	175,000 x 11.52%	20,160
6	175,000 x 5.76%	10,080
		$200,000

Note that Arlie will claim a total of $60,000 of depreciation in the first year.

Example 5. **Tangible personal property and bonus depreciation.** Betsy owns and operates a bakery. She purchased for use in her business a new piece of equipment (5-year property) for $20,000 and elected bonus depreciation. It was the only tangible personal property she purchased that year, and her business had taxable income of $100,000.

Because the cost of the property is less than $25,000, the most bonus depreciation she can claim is the cost of the property, or $20,000. After claiming bonus depreciation in the first year, Betsy has completely recovered the cost of the equipment.

Example 6. **Tangible personal property and bonus depreciation.** Chris owns and operates a candy store. He purchased for use in his business a new piece of equipment (5-year property) for $30,000 and elected bonus depreciation. It was the only tangible personal property he purchased that year, and his business had taxable income of $20,000.

Because the taxable income from his business is less than $25,000, the most bonus depreciation he can claim is the amount of taxable income, or $20,000. Chris recovers the remaining $10,000 cost of his property ($30,000 cost, less $20,000 of bonus deprecation) using his regular depreciation method.

Year	Calculation	Depreciation
1	Bonus	$20,000
1	$10,000 x 20%	2,000
2	10,000 x 32%	3,200
3	10,000 x 19.2%	1,920
4	10,000 x 11.52%	1,152
5	10,000 x 11.52%	1,152
6	10,000 x 5.76%	576
		$30,000

Note that Chris will claim a total of $22,000 of depreciation in the first year.

Example 7. **Tangible personal property and bonus depreciation.** Danny owns and operates a department store. He purchased for use in his business a new piece of equipment (5-year property) for $220,000 and elected bonus depreciation. It was the only tangible personal property he purchased that year, and his business had taxable income of $500,000.

Because he spent more than $200,000 on tangible personal property, the amount of bonus depreciation he can claim is reduced for every dollar he spent on tangible personal property over $200,000, or reduced by $20,000. Thus, he can claim $5,000 of bonus depreciation ($25,000 less $20,000) in the first year. Danny recovers the remaining $215,000 cost of his property ($220,000 cost, less $5,000 of bonus depreciation) using his regular depreciation method.

Year	**Calculation**	**Depreciation**
1	Bonus	$ 5,000
1	$215,000 x 20%	43,000
2	215,000 x 32%	68,800
3	215,000 x 19.2%	41,280
4	215,000 x 11.52%	24,768
5	215,000 x 11.52%	24,768
6	215,000 x 5.76%	12,384
		$220,000

Note that Danny will claim a total of $48,000 of depreciation in the first year.

D. Problems

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2. Dennis purchased an x-ray machine for use in his business. He paid $20,000 and, for tax purposes, the x-ray machine has a life of five years. He elected to claim bonus depreciation and his business had taxable income (before taking into consideration the depreciation) of $600,000 for the year. How much depreciation is he entitled to claim during each of the next six years?

3. Evan purchased a piece of equipment for use in his business. He paid $200,000 and, for tax purposes, the equipment has a life of five years. His business had taxable income (before taking into consideration the depreciation) of $600,000 for the year. How much depreciation is he entitled to claim during each of the next six years under the following alternative situations:

   a. He makes no elections.

   b. He elects to claim bonus depreciation.

   c. He makes no elections and sells the equipment in year three.

d. He elects bonus depreciation and sells the equipment in year three.

4. Frank purchased a piece of equipment for use in his business. The equipment has a life of five years. He elected to claim bonus depreciation. For the year his business had taxable income (before taking into consideration the depreciation) of $700,000. How much depreciation is he entitled to claim during the first year if the cost of the equipment is:

a. $150,000
b. $205,000
c. $250,000

5. Jack purchased a piece of equipment for use in his business. He paid $100,000 and, for tax purposes, the equipment has a life of five years. He elected to claim bonus depreciation. For the year his business had taxable income (before taking into consideration the depreciation) of $20,000. How much depreciation is he entitled to claim during in the first year?

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Chapter 37. Capital Assets

The tax rates applicable to long-term capital gains have changed. Replace Section **D. 2. Preferential Capital Gain Rates for Net Long-Term Capital Gain** (pages 324-326) with the following.

2. Preferential Capital Gain Rates for Net Long-Term Capital Gain

The tax rate applicable to net long-term capital gains depends on the nature of the asset sold and the taxpayer's tax bracket. The rate will be one of the following:

- 28 percent;
- 25 percent;
- 20 percent
- 15 percent
- 0 percent; or
- The tax rate applied to the taxpayer's ordinary income.

> **Tell Me More:**
>
> The tax rate applicable to long-term capital gain and the method of taxing long-term capital gain has varied over the years. For example, in 1921 the capital gains tax rate was 12.5 percent. In 1942, only one-half of long-term capital gain and loss was subject to tax and the net gain was taxed at the same rate as the taxpayer's other income. In 1951, the taxpayer was entitled to a deduction equal to one-half of his net long-term capital gains. In 1986, there was no preferential tax rate for capital gains.

Collectibles and Section 1202 gain. Collectibles gain is gain from the sale or exchange of any rug, antique, metal, gem, stamp, coin, or other collectible that has been held as a capital asset for more than one year.[7] "Section 1202" gain generally is 50 percent of the gain from the sale or exchange of certain stock described in Section 1202.[8]

If the taxpayer is in a tax bracket higher than 28 percent and the item sold is either "collectibles" or "Section 1202 gain," the maximum tax rate will be 28 percent. If the taxpayer would otherwise be in a lower tax bracket, the taxpayer's lower rate will apply.[9]

Example. Xander, who was in the 35 percent tax bracket, sold an antique rug he had purchased three years earlier for investment purposes. He recognized a long-term capital gain of $30,000. Because the gain was from a collectible and Xander would otherwise have been in a higher tax bracket, the gain from the rug will be taxed at the 28 percent rate. His remaining income will be taxed at the 35 percent rate.

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[7] Section 1(h)(5)(A).
[8] Section 1(h)(7).
[9] Section 1(h)(1)(E).

Alternatively, assume Xander had been in the 15 percent tax bracket when he sold the antique rug. He still recognized a long-term capital gain of $30,000. Because he was not in a tax bracket higher than 28 percent, the gain will be taxed at the 15 percent rate, the same as his other income.

Unrecaptured Section 1250 gain. In general, unrecaptured Section 1250 gain is long-term capital gain attributable to depreciation allowed with respect to real estate held for more than one year.[10] If the gain is "unrecaptured Section 1250 gain," it is taxed at a maximum rate of 25 percent.[11]

Example. Bob sold a building that he had used in his business for two years for $100,000. At the time of the sale, the adjusted basis in the building was $75,000 and he had claimed $25,000 of depreciation; he recognized $25,000 of gain. Because the gain from the sale was attributable to the depreciation taken by Bob prior to sale, the gain is characterized as unrecaptured Section 1250 gain and is taxed at a rate not higher than 25 percent.

Adjusted net capital gain. Adjusted net capital gain is the gain remaining after considering the previous two categories of gain, i.e., the net capital gain reduced by the amount of gain from collectibles, Section 1202 gain, and unrecaptured Section 1250 gain.[12] Adjusted net capital gain is taxed at a maximum rate of 20 percent. If the gain otherwise would have been taxed at the 10 or 15 percent marginal rate, it will be taxed at zero percent; if the gain otherwise would have been taxed at the 25, 28, 33, or 35 percent marginal rate, it will be taxed at 15 percent; if the gain otherwise would have been taxed at the 39.6 percent marginal rate, it will be taxed at 20 percent.[13]

Example. Erin is in the 35 percent tax bracket. She sold stock in GainCo and recognized a long-term capital gain of $20,000. Erin sold no other assets during the year. Because she had no collectibles, Section 1202, or unrecaptured Section 1250 gain, the adjusted net capital gain is $20,000. It will be taxed at the 15 percent rate. All other income will be taxed at the 35 percent rate. Alternatively, if Erin had been in the 10 percent tax bracket, the $20,000 of gain would not be subject to tax.

[10] Section 1(h)(6).
[11] Section 1(h)(1)(D).
[12] Section 1(h)(3).
[13] Section 1(h)(1)(B), (C).

Summary of Preferential Tax Rates

Gain From:	Highest Tax Rate	Lowest Tax Rate
Collectibles	28 percent	If lower, taxpayer's rate applicable to ordinary income (i.e., taxpayer does not receive a reduced rate).
50 percent of gain from Section 1202 stock	28 percent	If lower, taxpayer's rate applicable to ordinary income (i.e., taxpayer does not receive a reduced rate).
Unrecaptured Section 1250 gain	25 percent	If lower, taxpayer's rate applicable to ordinary income (i.e., taxpayer does not receive a reduced rate).
Remaining long-term capital gain ("adjusted net capital gain)	20 percent	If the gain otherwise would have been taxed at the 10 or 15 percent marginal rate, taxed at zero percent; if the gain otherwise would have been taxed at 25, 28, 33, or 35 percent marginal rate, taxed at 15 percent; if the gain otherwise would have been taxed at the 39.6 percent marginal rate, taxed at 20 percent.