

## §179 Expense Election

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### **Abstract:**

The §179 expensing election is increased to \$24,000 in 2001. This material discusses the basic rules that qualify property for the election.

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### **ISSUE 5: I.R.C. §179 EXPENSE ELECTION, ALLOWABLE DEDUCTIONS**

Taxpayers, except trusts, estates, and certain noncorporate lessors, can elect to expense up to \$24,000 (for tax year 2001), of the cost of certain MACRS property purchased and placed in service during the tax year. The expense election can be made only for qualifying personal property used in the active conduct of a trade or business. Property used for the production of income is disqualified. Property held for the production of income includes investment property, rental property, and property that produces royalty income. However, there are limits to the amount that can be expensed in a tax year.

### **What Costs Can Be Deducted?**

Costs that can be expensed include:

- The cost of property purchased for use in a trade or business
- The cash or “boot” paid for property acquired in a like-kind exchange for use in a trade or business.

**Example 1.** John Jones traded his business truck that had an adjusted basis of \$5,000, and paid cash boot of \$4,000, for a new truck. Only the \$4,000 cash boot paid is eligible for the I.R.C. §179 expense election.

**Practitioner Note.** The full expense deduction is allowed no matter when in the tax year the qualifying property is placed in service, even on the last day of the year. Also, a full deduction is allowed even if the property is placed in service in a short tax year.

**Planning Pointer.** For qualifying expense property, the mid-quarter and half-year depreciation conventions are avoided to the extent of the amount expensed.

### **Is the I.R.C. §179 Expense Election Optional?**

The expense deduction **is elective** and can be taken or not taken as the taxpayer chooses. And if taken in one year, it need not be taken again in a later

year in which the taxpayer buys qualifying property. However, it can only be taken in the year in which a depreciation deduction is first allowable with respect to the property, I.R.C. §179(c).

### **How to Make the Election**

The I.R.C. §179 deduction is not automatic. Make the election by reporting the deduction on Form 4562. Attach and **file Form 4562** with either of the following:

- The original tax return filed for the year the property was placed in service (whether or not timely filed)
- An amended return filed by the due date (including extensions) for the year the property was placed in service. The I.R.C. §179 election cannot be made on an amended return filed after the due date (including extensions)

If the return is timely filed without making the election, the election can still be made by filing an amended return within six months of the due date of the return (excluding extensions).

### **What Property Qualifies for the Election?**

Qualifying I.R.C. §179 property is depreciable property and includes the following:

1. Tangible personal property
2. Other tangible property (except buildings and their structural components) used as:
  - a. An integral part of manufacturing, production, or extraction or furnishing transportation, communications, electricity, gas, water, or sewage disposal services
  - b. A research facility used in connection with any of the activities in (a) above
  - c. A facility used in connection with any of the activities in (a) for the bulk storage of fungible commodities
3. Single purpose agricultural (livestock) or horticultural structures
4. Storage facilities (except buildings and their structural components) used in connection with distributing petroleum or any primary product of petroleum

**Leased Property.** Generally, the I.R.C. §179 deduction cannot be claimed for the cost of property leased to someone else. (This rule does not apply to corporations.) However, a taxpayer can claim an I.R.C. §179 deduction for the cost of the following:

1. Property the taxpayer manufactures or produces and leases to others
2. Property the taxpayer purchases and leases to others if both the following apply:
  - a. The term of the lease (including options to renew) is less than half of the property's class life
  - b. For the first 12 months after the property is transferred to the lessee, the total business deductions allowed on the property (other than rent and reimbursed amounts) are more than 15% of the rental income from the property

For a complete discussion and list of qualifying property see the *2000 Farm Income Tax School Workbook*, page 175.

### **What is the Annual Maximum Dollar Deduction Limit?**

The I.R.C. §179 expense deduction cannot be more than the property's cost and is subject to the taxable income limit and the following annual maximum dollar limits, which are reduced if qualified investments exceed \$200,000:

| <b><u>If the Tax Year Begins In:</u></b> | <b><u>The Applicable Amount Is:</u></b> |
|--|---|
| 1998                                     | 18,500                                  |
| 1999                                     | 19,000                                  |
| 2000                                     | 20,000                                  |
| <b>2001</b>                              | <b>24,000</b>                           |
| 2002                                     | 24,000                                  |
| 2003 or thereafter                       | 25,000                                  |

The annual maximum dollar limitation applies to each taxpayer and not to each trade or business in which the taxpayer has an interest [Reg. §1.179-2(a), and Reg §1.179-2(b)(1)].

**Example 2.** Mult I. Business-Owner has a Schedule C business in which he purchased \$20,000 of qualifying property. Mult I. also operates a Schedule F business in which he purchased \$12,000 of qualifying property. In 2001, Mult. I. has purchased a total of \$32,000 of qualifying property. However, his annual maximum dollar limitation is \$24,000.

**Example 3.** Assume Mult I. Business-Owner's wife, Uno, also owns a Schedule C business that purchased \$8,000 of qualifying property. Mult I. and Uno file a joint return in 2001. Among their three businesses, they have purchased a total of \$40,000 of qualifying property. However, their maximum annual dollar limit is \$24,000. The maximum amount, \$24,000, can be allocated to any of the qualifying assets.

### What is the Investment Limit?

The deduction for any year is reduced (but not below zero) by the amount of qualifying property placed in service during the tax year that exceeds the **\$200,000** investment limit [I.R.C. §179(b)(2)].

**Example 4.** Big Buyer placed \$215,000 of qualifying property in service during his 2001 tax year. The expense deduction for that year is limited to \$9,000.

|                           |                |               |
|---------------------------|----------------|---------------|
| 2001 limit                |                | \$24,000      |
| 2001 qualifying purchases | \$215,000      |               |
| Investment limit          | <u>200,000</u> |               |
| Excess                    |                | <u>15,000</u> |
| Limit on §179 deduction   |                | \$ 9,000      |

A husband and wife who file a joint return are treated as one taxpayer in applying the dollar limitation, regardless of which spouse bought the property or which spouse placed it in service. Reg. §1.179-2(b)(5)(i). A husband and wife may not deduct more than a total of the applicable maximum annual deduction even if they each bought separate properties and each owns separate businesses. The \$200,000 investment ceiling is figured using the total cost of qualifying property that **both** spouses placed in service during the year.

**Example 5.** Mult I. and Uno are both calendar-year taxpayers. During the 2001 tax year, Mult. I. places \$195,000 of qualifying property in service and Uno places \$9,000 of qualifying property in service. **Whether or not** Mult. I. and Uno file a joint return for 2001, their dollar limitation is \$20,000. [Reg. §1.179-2(b)(6)(ii)].

|                                |                |              |
|--------------------------------|----------------|--------------|
| 2001 limit                     |                | \$24,000     |
| Mult I.'s qualifying purchases | \$195,000      |              |
| Uno's qualifying purchases     | <u>9,000</u>   |              |
| Total qualifying purchases     | \$204,000      |              |
| Investment limit               | <u>200,000</u> |              |
| Excess                         |                | <u>4,000</u> |
| Limit on §179 deduction        |                | \$20,000     |

## What is the Taxable Income Limit?

The otherwise allowable expense deduction is limited to the aggregate amount of taxable income from any of the taxpayer's active trades or businesses [I.R.C. §179(b)(3)(A)].

Taxable income from a trade or business includes the following items:

- I.R.C. §1231 gains and losses
- Interest from trade or business working capital
- Wages, salaries, tips, or other pay earned as an employee

## How is the Income Limitation Applied to Married Taxpayers?

A husband and wife who file a joint return must:

- Combine their taxable income for purposes of the taxable income limitation
- The same rule applies to a husband and wife who file separate returns for a tax year and then
- elect to file a joint return after the time prescribed for filing the return for that year has expired
- Married taxpayers filing separately determine their taxable income limitations separately

**Example 6.** John has a \$10,000 loss from his Schedule C business; Mary has \$12,000 net income from her business. John and Mary have no other income and file a joint return. John and Mary could elect to expense \$2,000 I.R.C. §179 property even if it were purchased and used in John's business.

**Observation.** The taxable income limitation doesn't prevent an expense deduction simply because the trade or business in which the qualifying property is used produces no income for the year of investment. As long as the taxpayer has aggregate taxable income from active trades or businesses, the deduction is allowed. The converse is also true. If the taxpayer has taxable income from the business in which the qualifying property is used but does not have aggregate taxable income because another business showed a loss, no

expense deduction is available. In that case, however, a carryover would be allowed.

### **How is Taxable Income Computed?**

Taxable income, for purposes of the taxable income limitation, is computed without regard to the expense deduction itself, and without regard to:

1. The deduction under I.R.C. §164(f) for one-half of self-employment tax
2. Any net operating loss carryback or carryforward, and
3. Any deductions suspended under other I.R.C. sections. [Reg. §1.179-2(c)(1)]

**Example 7.** Jim Smith bought an item of construction equipment for \$10,000. The net income from Jim Smith's construction business is \$200,000. Jim also owns and actively manages an office building that produces a \$200,000 rental loss. For Jim, however, the I.R.C. §469 passive activity rules prevent current deduction of the rental loss. Under the above "deduction-suspension" rule, the rental loss does not reduce the income from Jim Smith's construction business for purposes of the taxable income limitation. Therefore, Jim may elect to expense \$10,000, the full cost of the construction equipment.

### **Can Deductions in Excess of the Taxable Income Limit Be Carried to a Future Year?**

Only §179 deductions in excess of the taxable income limitation can be carried forward. Deductions that exceed the maximum annual dollar limitation are wasted and cannot be carried forward.

**Example 8.** Ralph Roush in 2001 has taxable income from his Schedule C business of \$30,000. He has purchased \$28,000 of qualified property and attempted to expense the full amount. However, his deduction is limited to the maximum annual dollar limitation for 2001, \$24,000. The excess \$4,000 cannot be carried forward.

**Example 9.** Assume the same facts as above except Ralph's taxable income is \$15,000. Ralph elects \$24,000, the maximum I.R.C. §179 expense election for 2001. He can deduct \$15,000 for 2001. The remaining \$9,000 can be carried to any future year.

**Observation.** Even if the business in the above example doesn't have \$24,000 of taxable income for 2001, the benefit of the election is not lost, but only

postponed to future years to the extent the expensed amount exceeds taxable income. If the business has zero taxable income (before the election) for Year 2001, the expense election ensures the business a deduction for *any* future year when the business does have taxable income. Without the election, the carryover deduction is lost for any later year. However, the taxpayer can take regular depreciation for the property in the later year.

### **How Does the Carryover of the I.R.C. §179 Expense Effect Future Year's Annual Dollar Limitation?**

Any expense deduction that cannot be used because of the taxable income limitation is carried forward indefinitely to future years. The carryover can be deducted to the extent that, when added to amounts for which the taxpayer makes the expense election for that year, it does not exceed the dollar limitations and the taxable income limitation for that year. Carryovers not deductible because of the taxable income limitations can continue to be carried forward to future years [I.R.C. §179(b)(3)(B)].

**Example 10.** Mary, a calendar-year taxpayer, has a \$3,000 carryover of a disallowed I.R.C. §179 expense deduction from a past tax year. In 2001 Mary places in service qualifying property that cost \$25,000. Mary's 2001 taxable income from active trades and businesses is \$100,000. Mary elects to expense \$22,000 of the cost of the qualifying property placed in service in 2001. Because of the \$24,000 limitation (for 2001), Mary can deduct the \$22,000 of current year expense and \$2,000 of the carryover. Mary has a \$1,000 carryover remaining for use in future years [Reg. §1.179-3(d)].

### **Can Personal-Use Property Converted to Business Use Qualify for the I.R.C. §179 Expense?**

The determination of whether property is qualifying property is made in the first year the property is placed in service. If the taxpayer places property in service in a tax year and the property does not qualify for the expense deduction, **no expense deduction is allowed** for the property even though the property later becomes qualifying property in a future tax year [IRS Pub No. 946, (2000), p. 14]. However, the taxpayer can take regular depreciation for the property in the later year.

**Example 11 .** In year 1, Mike bought a new car and used it 100% for personal purposes. In the following year (year 2), Mike begins to use the car in his business. The car is not qualifying property to Mike for purposes of the expense election. However, Mike can depreciate the car in year 2.