The basics of depreciation

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This bulletin will help you understand various Internal Revenue Service regulations and publications as they apply to your marine business. It is not a substitute for IRS regulations and publications, or for expert counsel you may obtain from the IRS or professional tax practitioners.

You may deduct each year, as depreciation, a reasonable allowance for the exhaustion, wear and tear, and obsolescence of depreciable property used in your trade or business or held for the production of income. What follows is a highly condensed explanation of depreciation, for tax purposes. For more detailed information on depreciation for tax purposes, consult IRS Publications 595 and 534.

Steps in determining depreciation
1. Determine whether a particular cost item represents a capital expenditure or a deductible expense. (See "Glossary of terms," page 3.)
2. Determine the "basis" and "adjusted basis" for depreciation of capital expenditures.
3. Determine a useful life for the property.
4. Estimate a salvage value at the end of its useful life in the business.
5. Decide whether the property qualifies for "Additional first-year depreciation."
6. After deciding whether or not to take the additional first-year depreciation, select the most suitable allowed method of depreciation for property, and set up a depreciation schedule based upon the adjusted basis.

Capital expenditures versus repairs
Capital expenditures represent investments of capital either to acquire property with a useful life of more than one year or to make permanent improvements or betterment that increase the value of the property or appreciably prolong its life. Capital expenditures must be depreciated.

Repairs merely maintain the property in an ordinarily efficient operating condition over its estimated useful life, for the purposes for which it was acquired. Repairs are deductible in the year they occur.

Choosing to capitalize
In certain circumstances, the Federal income tax laws permit you to choose either to claim a current deduction or to capitalize specified types of expenditures. Thus you may choose to treat as capital expenditures certain items that you would otherwise deduct currently, or you may choose to deduct currently certain items you would otherwise treat as capital expenditures. You may capitalize carrying charges, interest, and certain taxes that are otherwise deductible with respect to certain personal property (a boat engine, electronic gear, etc.), if you so choose.

Basis of business assets
"Basis" of property is used in determining the deduction for depreciation. The cost or purchase price of the property generally is the original basis. However, if the property was acquired by gift or inheritance, or in some other manner, an original "basis other than cost" must be used.

When the cost or purchase price of a piece of property is used as the basis for depreciation, this total should also include "settlement fees" (sales commissions, legal and filing fees, etc.). The basis should be the total cost to you including cash, debt obligations, or other property.

There are cases where a basis other than cost must be used. Here fair market value plays a part. The IRS defines "fair market value" as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of all relevant facts."

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Adjusted basis

Adjusted basis depends upon additions and reductions:

Additions. The basis of any property is increased by all items or expenditures that are properly chargeable to capital account (except as noted later). Included in this category is the cost of any improvements made to property that have a useful life of more than one year. The costs of purchase commissions, legal fees such as the cost of defending and perfecting titles (including title insurance), and recording fees, are also added to the basis of property.

Reductions. You must decrease the basis of your property by any items that represent a return of capital. These include such things as additional first-year depreciation, recognized losses on involuntary conversions, and casualty losses; and deductions previously allowed (or allowable) for amortization, depreciation, obsolescence, and depletion. You do not reduce basis because of the investment credit.

Depreciation restrictions

The kind of property on which you ordinarily may claim the depreciation deduction is property with a useful life of more than one year. It must also be for business. You may not deduct depreciation on property you and your family use as a residence, your automobile used solely for pleasure or for commuting, etc.

You may deduct depreciation on tangible property (see "Glossary"). Buildings may be depreciated; land may not.

If intangible property (see "Glossary") used in your business has a limited period of usefulness, it may be depreciated. Your unsupported opinion is not sufficient to establish that fact, but your experience and other factors may be used in the determination.

Amount of depreciation deduction

You should take the proper depreciation in each tax year. If you failed to deduct allowable depreciation in past years, you may not deduct the unclaimed depreciation in the current or a later tax year. If you acquire or dispose of property during the year, and do not use an averaging convention, regular depreciation is allowable for only part of the year. Depreciation begins when the property is placed in service and ends when the property is retired from service.

Useful life

The first step in computing depreciation is to determine the estimated useful life of the property. No average useful life is applicable in all businesses. The useful life of any property depends upon such things as the frequency with which you use it; its age when you acquired it; your policy as to repairs, renewals, and replacements; the climate in which it is used; and the normal progress of the arts, economic changes, inventions, and other developments within the industry and your trade or business.

You should determine the useful life of the depreciable property on the basis of your particular operating conditions and experience. If your experience is inadequate, you may use the general experience in the industry until your own experience forms an adequate basis for making the determination.

Salvage value

Salvage value is the amount (determined at the time of acquisition) that you estimate will be realized on sale or other disposition of the property when it is no longer useful in your business or in the production of your income and is to be retired from service.

Additional first-year depreciation

You may choose to deduct 20% of the cost of qualifying property (subject to a dollar limitation discussed later) as additional first-year depreciation, in addition to your regular depreciation. You do not use salvage in computing this deduction.

You may take this deduction only in the first year for which depreciation deduction is allowable on the property. This is ordinarily the year in which you acquire the property.

New or used tangible personal property having a useful life of at least six years (determined at date of acquisition) qualifies for additional first-year depreciation. Buildings, their structural components, land, and intangible personal property such as patents, do not qualify for the deduction.

The cost of property on which you may take this additional allowance is limited to $10,000 on a separate return and $20,000 on a joint return.

The additional first-year depreciation deduction is determined without adjustment to basis for salvage value and is allowed in full, even though you acquire the property during the year. You then compute ordinary depreciation on the cost or other basis of the property, less the additional first-year depreciation deduction and salvage value.

Methods of computing depreciation

The three methods most generally used in computing depreciation are:

1. Straight line
2. Declining balance
3. Sum of the years-digits

There are other acceptable methods that you can use as long as the rate of depreciation for different types of property stays within the limits established in the IRS Code. If you plan to use any method other than simple straight-line depreciation, it is recommended that you get copies of the IRS publications and contact an IRS office for allowable methods and rates.
Straight-line method. The cost or other basis of the property, less its salvage value, is deducted in equal annual amounts over the period of its estimated useful life. To determine the depreciation for each year, divide the adjusted basis of the property, less salvage value, by the remaining useful life. You must use this method for any depreciable property for which you have not adopted a different acceptable method.

Declining-balance method. The depreciation you take each year is subtracted from the cost or other basis of the property before computing the next year's depreciation. The same depreciation rate applies to a smaller or declining balance each year. Thus, a larger depreciation deduction is taken for the first year and a gradually smaller deduction in succeeding years.

Within limits, the depreciation rate used is greater than the rate that would be used under the straight-line method. Under some circumstances, you may use a rate twice as great as would be proper under the straight-line method. Under other circumstances, you are limited to a rate 1% or 11/2 times as great as the rate you would use under the straight-line method.

You do not deduct salvage value from the cost or other basis of your property in determining the annual depreciation allowance under the declining-balance method. However, you must not depreciate your property below its reasonable salvage value.

Twice the straight-line rate may be used to compute depreciation under this method, on tangible personal property having a useful life of three years or more that is acquired new or is constructed or erected by you after December 31, 1953.

Example. Assume you purchased new electronic gear in January of this year, for $2,000, and its estimated life is ten years. Under the straight-line method of computing depreciation, the rate is 10%. Since this electronic gear meets all the conditions stated above, you may depreciate it under the declining-balance method at a rate twice the straight-line rate, or 20%. Your depreciation allowance on this equipment for this year is $400, which is 20% of $2,000. Your depreciation allowance the following year is $320, or 20% of $1,600 ($2,000 minus $400).

Sum of the years-digits method. This method may be used only on property that meets the requirements for twice the straight-line method under declining-balance method. Under this method, you apply a different fraction each year to the cost or other basis of each single-asset account reduced by estimated salvage value. The denominator of the fraction, which remains constant, is the sum of the digits representing the years of estimated useful life of the property. For example, if the estimated useful life is five years, the denominator is 15, that is, the sum of 1+2+3+4+5.

The numerator of the fraction changes each year to represent the years of useful life remaining at the beginning of the year for which the computation is made. For the first year of a five-year estimated useful life, the numerator would be 5, for the second year 4, etc. Thus, for property with an estimated useful life of five years, the fraction you apply to the cost or other basis, minus salvage value, to compute depreciation for the first year, is 5/15. The fractions for the second, third, fourth, and fifth years are 4/15, 3/15, 2/15, and 1/15, respectively.

Reference materials
IRS Publication 534, Tax Information on Depreciation.

Glossary of terms
Depreciation—A reasonable allowance, which may be deducted each year, for the exhaustion, wear and tear, and obsolescence of depreciable property used in your trade or business or held for the production of income.
Depreciable property—Property with a useful life of more than one year that is used in your trade or business or held for the production of income.
Capital expenditures—Expenditures for the purchase, construction, reconstruction, shipment, installation, and the like, for pieces of depreciable property (property with a useful life of greater than one year).
Deductible expenses—Expenses on items with a life less than one year or which are considered consumed within that year.
Real property, personal property, tangible personal property, intangible personal property—Real property refers to land, buildings, and other such improvements. Personal property includes tangible items (trucks, fishing boats, nets, and the like) and intangible items (franchises, licenses, goodwill, etc.).
Useful life—The length of time that a piece of property is expected to be used in your trade or business or held for the production of income.
Salvage value—The amount (determined at the time of acquisition) that you estimate will be realized on the sale or other disposition of a piece of property when it has reached the end of its "useful life" (based upon its depreciation schedule).
Additional first-year depreciation—A deduction of 20% of the cost of used or new tangible personal property with a useful life of six years or more that may be taken (with certain dollar limitations) in addition to the regular depreciation.