Chapter 8

Depreciation Under IRS Rules

Important Note
This chapter explains how to depreciate, for tax purposes, assets purchased in 2000 or thereafter. Prior to 2000, there were many changes in tax depreciation rules, rates and regulations. Therefore, for assets purchased before 2000, it is assumed that you and your client will continue to use the depreciation methods, rates and tables on the company's tax depreciation schedules.

Overview of Depreciation
For the sake of simplicity, many businesses, particularly small ones, use the same method to compute depreciation for both financial reporting (GAAP) and tax reporting (IRS) purposes. Either way is acceptable. What's important, if you choose to use a different method for book purposes, it must be consistent. This is an important accounting priciple that must be observed by the companies. Once you've selected a method, retain it from year to year. Consistency is a very important accounting rule.

Introduction
Under tax rules, most assets must be depreciated using the Modified Accelerated Cost Recovery System (MACRS, pronounced "makers"). MACRS requires few computations because IRS Publication 946, How to Depreciate Property, contains tables of depreciation rates. Because MACRS depreciation is based on the same basic concepts as GAAP, many companies use MACRS for both tax and book (financial statement) purposes if their statements do not have to undergo an audit or review, or if the difference between GAAP vs. MACRS is not material. However, MACRS does differ from GAAP as follows:

- **Under MACRS, the entire acquisition cost is depreciated; there is no residual value.** Under MACRS, a fully depreciated asset has a book value of $0. For example, if your company buys equipment with an acquisition cost of $150,000 and estimates a residual value of $25,000, the $150,000 cost is used to determine annual tax depreciation and the entire $150,000 is eventually depreciated, leaving a book value of $0. The company's estimate of a $25,000 residual value is ignored.

- **Under MACRS, the IRS (not the company) determines the asset's life (recovery period)**. MACRS assigns all assets to specified class lives (recovery periods).

IRS Depreciation
As we have explained in earlier chapters, depreciation is an annual deduction for recovery of the purchase price of a fixed asset. It is composed of several very complicated systems. This chapter offers a very basic exploration of the IRS depreciation. A tax preparer who will be doing returns with depreciation should plan to do much further study. IRS Pub. 946, How to Depreciate Property, has good information on depreciation.