A Brief Overview of Depreciation

Depreciation is an income tax deduction that allows a taxpayer to recover the cost or other basis of certain property. It is an annual allowance for the wear and tear, deterioration, or obsolescence of the property.

Most types of tangible property (except, land), such as buildings, machinery, vehicles, furniture, and equipment are depreciable. Likewise, certain intangible property, such as patents, copyrights, and computer software is depreciable.

In order for a taxpayer to be allowed a depreciation deduction for a property, the property must meet all the following requirements:

- The taxpayer must own the property. Taxpayers may also depreciate any capital improvements for property the taxpayer leases.
- A taxpayer must use the property in business or in an income-producing activity. If a taxpayer uses a property for business and for personal purposes, the taxpayer can only deduct depreciation based only on the business use of that property.
- The property must have a determinable useful life of more than one year.

Even if a taxpayer meets the preceding requirements for a property, a taxpayer cannot depreciate the following property:

- Property placed in service and disposed of in same year.
- Equipment used to build capital improvements. A taxpayer must add otherwise allowable depreciation on the equipment during the period of construction to the basis of the improvements.
- Certain term interests.

Depreciation begins when a taxpayer places property in service for use in a trade or business or for the production of income. The property ceases to be depreciable when the taxpayer has fully recovered the property's cost or other basis or when the taxpayer retires it from service, whichever happens first.

A taxpayer must identify several items to ensure the proper depreciation of a property, including:

- The depreciation method for the property
- The class life of the asset
- Whether the property is "Listed Property"
- Whether the taxpayer elects to expense any portion of the asset
- Whether the taxpayer qualifies for any "bonus" first year depreciation
- The depreciable basis of the property

The Modified Accelerated Cost Recovery System (MACRS) is the proper depreciation method for ***most*** property. Additional information about MACRS, and the other components of depreciation are in Publication 946, How to Depreciate Property.

A taxpayer must use Form 4562, Depreciation and Amortization, to report depreciation on a tax return. Form 4562 is divided into six sections and the Instructions for Form 4562 contain information on how, and when to fill out each section.