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**Notes: Use this Revenue Procedure to assist in computing depreciation in connection with Notice 2001-70 also on this website.**

REV-PROC, 89FED ¶6386, Depreciation: Tangible property: Guidance.--, Revenue Procedure 89-15, 1989-1 CB 816, (Feb. 10, 1989)

**Revenue Procedure 89-15, 1989-1 CB 816, February 10, 1989.1989-9 I.R.B**.

[Code Sec. 168]

Depreciation: Tangible property: Guidance.--The Internal Revenue Service provides guidance for computing depreciation allowances for tangible property under Code Sec. 168 when (1) property is placed in service in a **taxable year of less than 12 full months**, (2) property is disposed of prior to the end of the recovery period, or (3) the recovery period for the property includes all or part of a short taxable year other than the year property is placed in service.

SECTION 1. PURPOSE

This revenue procedure provides guidance for computing depreciation allowances for tangible property under section 168 of the Internal Revenue Code when (1) property is placed in service in a taxable year of less than 12 full months **(a short taxable year**), (2) property is disposed of prior to the end of the recovery period, or (3) the recovery period for the property includes all or part of a short taxable year other than the year property is placed in service.

SEC. 2. BACKGROUND

In general, section 168 of the Code determines the amount and timing of depreciation deductions for tangible property placed in service after December 31, 1986.

The applicable depreciation methods under section 168(b) of the Code are:

(1) for 3-year, 5-year, 7-year, and 10-year property (except any tree or vine bearing fruit or nuts), the 200 percent declining balance method, switching to the straight line method for the first taxable year for which using the straight line method with respect to the adjusted basis as of the beginning of such year will yield a larger allowance,

(2) for 15-year and 20-year property, any property used in a farming business (within the meaning of section 263A(e)(4)), and any property (other than property to which the straight line method applies) subject to an election under section 168(b)(2)(C) and (5), the 150 percent declining balance method, switching to the straight line method for the first taxable year for which using the straight line method with respect to the adjusted basis as of the beginning of such year will yield a larger allowance, and

(3) for residential rental property, nonresidential real property, any railroad grading or tunnel bore, property subject to an election under section 168(b)(3)(D) and (5), any tree or vine bearing fruit or nuts, and property subject to the alternative depreciation system of section 168(g), the straight line method.

The applicable recovery periods are determined under sections 168(c) and 168(g)(2)(C) of the Code.

Section 168(d) of the Code prescribes the conventions used to determine, for purposes of section

168, when property is treated as placed in service or disposed of. These conventions are used in computing depreciation allowances for the taxable year in which property is placed in service or disposed of.

Section 168(d)(1) of the Code provides that, in general, the applicable convention is the half-year convention. Section 168(d)(4)(A) defines the half-year convention as a convention that treats all property placed in service during any taxable year (or disposed of during any taxable year) as placed in service (or disposed of) on the mid-point of the taxable year.

Section 168(d)(2) of the Code provides that, for nonresidential real property, residential rental property, and any railroad grading or tunnel bore, the applicable convention is the midmonth convention. Section 168(d)(4)(B) defines the mid-month convention as a convention that treats all property placed in service during any month (or disposed of during any month) as placed in service (or disposed of) on the mid-point of the month.

Section 168(d)(3) of the Code generally provides that, if during a taxable year (i) the aggregate basis of property to which section 168 applies that is placed in service in the last 3 months of the taxable year exceeds (ii) 40 percent of the aggregate basis of property to which section 168 applies that is placed in service during such taxable year, then the applicable convention for all property to which section 168 applies that is placed in service during such taxable year is the mid-quarter convention. 1 Nonresidential real property and residential rental property are not taken into account for purposes of determining whether the mid-quarter convention applies, nor does that convention apply to such property even if the convention is otherwise applicable. Section 168(d)(4)(C) of the Code defines the mid-quarter convention as a convention that treats all property placed in service during any quarter of a taxable year (or disposed of during any quarter of a taxable year) as placed in service (or disposed of) on the mid-point of the quarter.

In determining whether section 168(d)(3) of the Code requires use of the mid-quarter convention, the taxpayer must look to the aggregate basis of property placed in service in the last 3 months of the taxable year, whatever the length of the taxable year. Thus, if a short taxable year consists of 3 months or less, the mid-quarter convention applies regardless of when the depreciable property is placed in service during the taxable year.

The half-year, mid-quarter, and mid-month conventions prescribed by section 168(d) of the Code establish deemed placed-in-service dates and deemed disposition dates. Depreciation is allowable only for the portion of a taxable year the property is treated as in service. 2 The recovery period begins on the placed-in-service date prescribed by section 168(d). The remaining recovery period as of the beginning of the taxable year following the taxable year in which the property is placed in service is equal to the full applicable recovery period less the fraction of the first taxable year for which depreciation is allowable. Section 4.01 of this revenue procedure provides procedures for determining placed-in-service dates and disposition dates in short taxable years.

Depreciation allowances are determined on a taxable year basis. In contrast, the applicable recovery periods under section 168(c) of the Code are based on recovery years without regard to the taxpayer's underlying taxable year. The number of years in the recovery period determines the applicable depreciation rate under each of the methods provided in section 168(b). The product of (1) the annual applicable depreciation rate and (2) the adjusted basis of the property as of the beginning of the recovery year is the depreciation attributable to that recovery year.

Because of the applicable placed-in-service conventions, an asset's recovery year generally will not coincide with the taxpayer's taxable year. The depreciation attributable to a recovery year is consequently allocated to the taxable years that include the recovery year. For the taxable year in which the recovery period begins, the property is deemed in service for only a portion of the taxable year, and the depreciation allowance must be adjusted accordingly. The depreciation allowances for subsequent taxable years must account for the difference between recovery years and taxable years. Section 4.02 and section 4.03 of this revenue procedure provide rules for allocating depreciation allowances to taxable years when the recovery period includes a short taxable year or when the property is disposed of prior to the end of the recovery period.

Section 5 of Rev. Proc. 87-57, 1987-2 C.B. 687, describes the use of the applicable conventions when property is placed in service during a taxable year of 12 full months. The tables in section 8 of Rev. Proc. 87-57 take into account the applicable conventions and assume that the taxable year in which the property is placed in service and all subsequent taxable years in the recovery period are full taxable years. The tables further assume that the property is not disposed of during the recovery period. If at any time during the recovery period the taxpayer has a short taxable year or disposes of property, the tables in section 8 of Rev. Proc. 87-57 are inapplicable and this revenue procedure must be followed.

SEC. 3. SCOPE

.01 Except as provided in section 3.02, this revenue procedure applies in any taxable year in which property subject to section 168 of the Code is treated as in service for fewer than 12 full months or has been so treated for some prior taxable year in the recovery period. Thus, if, before the end of the recovery period, the taxpayer has a short taxable year or disposes of the property before the end of the recovery period, the procedures provided in section 4 of this revenue procedure apply in computing the depreciation allowances.

.02 If the taxable year in which property is placed in service is 12 full months, the fact that the applicable conventions treat such property as in service for less than 12 full months shall not be grounds for applying this revenue procedure. Rev. Proc. 87-57 provides rules for implementing the applicable conventions in taxable years of 12 full months.

SEC. 4. PROCEDURES

.01 Property Placed in Service or Disposed of During a Short Taxable Year.

(1) Applicable Conventions. Section 168(d)(4) of the Code applies both the half-year convention and the mid-quarter convention to the “taxable year.” Consideration of the taxable year of the taxpayer is thus necessary in establishing the date property is treated as placed in service or disposed of. The mid-month convention, however, is applied without regard to the taxpayer’s taxable year.

(a) Half-year convention. Property subject to the half-year convention is deemed placed in service or disposed of on the mid-point of the taxable year in which the property is placed in service or disposed of. For purposes of determining the date property subject to the half-year convention is deemed placed in service or disposed of, the following additional rules apply:

(i) For a short taxable year that begins on the first day of a month or ends on the last day of a month, the taxable year, for purposes of section 168 of the Code, shall consist of the number of months in the taxable year. (For this purpose, if the short taxable year includes part of a month, the entire month shall, in general, be included in the number of months in the taxable year.) The mid-point of the taxable year is then determined by dividing the number of months in the taxable year by 2. For example, a short taxable year that begins on June 20 and ends on December 31 consists of 7 months and the mid-point of the taxable year is the middle of September. Property is treated as placed in service or disposed on this mid-point.

However, no month shall be taken into account more than once. Thus, if a taxpayer has successive short taxable years, with one taxable year ending and the following taxable year beginning in the same calendar month, the first short taxable year shall be treated, for this purpose, as not including the month in which the first short taxable year terminates. For example, if a taxpayer had a short taxable year beginning on June first and ending on October 15 followed by a short taxable year beginning on October 16 and ending on May 31, the first short taxable year would thus consist of four months and its mid-point would be the end of July. The second short taxable year would consist of eight months and its mid-point would be the end of January.

(ii) For a short taxable year that begins on a day other than the first day of a month and ends on a day other than the last day of a month, the taxable year shall be measured by the number of days in the short taxable year. The arithmetical mid-point of the taxable year is then determined by dividing the number of days in the taxable year by 2. If the arithmetical mid-point of the taxable year is a day other than the first or the mid-point of a month, property is treated as placed in service or disposed of on the nearest preceding first or mid-point of the month.

Thus, under these rules, property subject to the half-year convention is always treated as placed in service or disposed of on either the first day or the mid-point of a month.

(b) Mid-quarter convention. Property subject to the mid-quarter convention is deemed placed in service or disposed of on the mid-point of the quarter of the taxable year in which the property is placed in service or disposed of. The taxpayer must divide a short taxable year into four quarters and then determine the mid-point of each quarter. For purposes of determining the date property subject to the mid-quarter convention is deemed placed in service or disposed of, the following additional rules apply:

(i) For a short taxable year that consists of four or eight full calendar months, the taxpayer determines quarters on the basis of whole months. Thus, the mid-point of each quarter is either the first or the mid-point of a month, and property is treated as placed in service or disposed of on the mid-point.

(ii) For a short taxable year that consists of anything other than four or eight full calendar months, the taxpayer determines the number of days in the taxable year, divides by 4 to determine the length of each quarter, and determines the arithmetical mid-point by dividing the number of days in each quarter by 2. If the arithmetical mid-point of a quarter is a day other than the first or the mid-point of a month, property is treated as placed in service or disposed of on the nearest preceding first or mid-point of the month.

Thus, under these rules, property subject to the mid-quarter convention is always treated as placed in service or disposed of on either the first or the mid-point of a month.

(c) Mid-month Convention. Property subject to the mid-month convention is deemed placed in service or disposed of on the mid-point of the calendar month in which the property is placed in service or disposed of.

.02 Depreciation Allowance for First Taxable Year in the Recovery Period. To determine the depreciation allowance for the first taxable year in the recovery period, the taxpayer must initially determine the depreciation attributable to the first recovery year. The depreciation attributable to the first recovery year is obtained by multiplying the taxpayer’s basis in the property by the applicable depreciation rate. The depreciation allowance allocable to the first taxable year is then obtained by multiplying the depreciation attributable to the first recovery year by a fraction, the numerator of which is the number of months (including fractions of months) the property is deemed to be in service during the taxable year (taking into account the applicable convention) and the denominator of which is 12.

.03 Depreciation Allowances for Subsequent Taxable Years in the Recovery Period. Taxpayers may use either the allocation method or the simplified method in computing depreciation allowances for subsequent years in the recovery period. The method adopted must be consistently applied until the year of switch to the straight line method.

(1) Allocation Method. The depreciation allowance for each subsequent taxable year is calculated by allocating to the taxable year the depreciation attributable to each recovery year, or portion thereof, that falls within the taxable year. Thus, whether the taxable year is a 12-month or a short taxable year, the depreciation allowance is calculated by determining which recovery years are included in the taxable year. For each recovery year included, the depreciation attributable to each recovery year is multiplied by a fraction, the numerator of which is the number of months (including fractions of months) that are in both the taxable year and the recovery year and the denominator of which is 12.

In the case of property disposed of before the end of the recovery period, the applicable conventions, as described in section 4.01, determine when the property is treated as disposed of.

(2) Simplified Method. In lieu of the allocation method described above, the taxpayer may calculate depreciation allowances for subsequent taxable years by multiplying the unrecovered basis of the property as of the beginning of the taxable year by the applicable depreciation rate. If a subsequent taxable year during the recovery period is a short taxable year or is a year in which the taxpayer disposes of the property, the depreciation allowance for the taxable year must be adjusted in a manner similar to that described in section 4.02, above. Thus, in the case of a subsequent short taxable year, the depreciation allowance is obtained by multiplying the unrecovered basis of the property as of the beginning of the taxable year by the applicable depreciation rate, and then multiplying the product by a fraction, the numerator of which is the number of months (including fractions of months) in the taxable year and the denominator of which is 12. In the case of a disposition before the end of the recovery period, the applicable convention determines when property is treated as disposed of for purposes of section 168 of the Code. The depreciation allowance for such property is obtained by multiplying the unrecovered basis of the property as of the beginning of the taxable year by the applicable depreciation rate, and then multiplying the product by a fraction, the numerator of which is the number of months (including fractions of months) the property is deemed in service during the taxable year and the denominator of which is 12. This simplified approach is consistent with section 6.06 of Rev. Proc. 87-57.

(3) Declining Balance Method with Switch to Straight Line Method. If the taxpayer depreciates property by use of the applicable depreciation method provided by section 168(b)(1) or (2) of the Code, the taxpayer must switch to the straight line method for the first taxable year that the straight line method produces a larger allowance. Therefore, for each taxable year, the taxpayer must compare the depreciation allowance calculated under the declining balance method with the depreciation allowance calculated under the straight line method. Under the straight line method, the applicable depreciation rate for each taxable year, except the last taxable year in the recovery period, is determined by dividing 1 by the number of years (including fractions of years) in the applicable recovery period remaining as of the beginning of such taxable year. For the taxable year in which the recovery period ends, the applicable depreciation rate under the straight line method is 100 percent. The applicable depreciation rate is then applied to the unrecovered basis of the property as of the beginning of that taxable year.

.04 Alternative Minimum Tax. In calculating the adjustment to taxable income under section 56 of the Code, depreciation allowances should reflect short taxable years in a manner consistent with that described above.

.05 Depreciation Deductions for Short Taxable Years for which a Return has been Filed. In the case of property subject to the half-year or mid-quarter convention that was placed in service or disposed of during a short taxable year for which a return was filed before the publication of this revenue procedure, taxpayers should file amended returns in a timely manner. However, if the depreciation deduction(s) claimed reflect placed-in-service dates and disposition dates on a more exact basis than this revenue procedure, the Service will not disturb this treatment on examination. Taxpayers not filing amended returns should compute depreciation deductions for subsequent taxable years in the recovery period consistent with the placed-in-service dates adopted on the return for the year the property was placed in service.

SEC. 5. EXAMPLES

.01 Half-year convention.

Example

FACTS. Corporation X, a calendar year taxpayer, was incorporated and began business on March 15, 1988. During its 1988 taxable year, X placed in service tangible personal property subject to an allowance for depreciation determined under section 168 of the Code. Assume that the applicable convention is the half-year convention.

ANALYSIS. X has a short taxable year that begins March 15, 1988, and ends December 31, 1988, and thus is treated as having a 10-month taxable year under section 4.01(1)(a)(i), above. The property placed in service during the short taxable year is therefore treated as placed in service on the first day after the 5th month in the taxable year, that is, on August 1, 1988.

.02 Mid-quarter convention.

Example (1)

FACTS. Assume the same facts as in section 5.01, except that the applicable convention is the mid-quarter convention.

ANALYSIS. Section 4.01(1)(b)(ii), above, applies to the property. X's short taxable year consists of 292 days. Each quarter is 73 days, and the arithmetic mid-point of each quarter is the 37th day of the quarter. The arithmetic mid-point of the first quarter is thus April 20, 1988. Under section 4.01(1)(b)(ii), the mid-point of the first quarter is the middle of April. Table 1 illustrates the application of section 4.01(1)(b)(ii) under these facts.

Rev. Proc. 89-15, Table 1

Example of application of the mid-quarter convention in a short taxable year beginning March 15, 1988 and ending December 31, 1988.

| Quarter | Arithmetic Mid-point of the Quarter | Deemed Placed-in-Service Date |
|---|---|---|
| 1. March 15 to May 26, 1988 .. | April 20, 1988 | Middle of April |
| 2. May 27 to August 7, 1988 .. | July 2, 1988 | Beginning of July |
| 3.August 8 to October 19, 1988. | September 13, 1988 | Beginning of September |
| 4.October 20 to December 31,1988 | November 25, 1988 | Middle of November |

Example (2)

FACTS. Corporation Z, a calendar year taxpayer, was incorporated and began business on December 1, 1988. During its 1988 taxable year, Z placed in service tangible personal property subject to an allowance for depreciation under section 168 of the Code. Z has a short taxable year that begins December 1, 1988, and ends December 31, 1988. The applicable convention is the mid-quarter convention.

ANALYSIS. X has a 31-day short taxable year. Table 2 illustrates the application of section 4.01(1)(b)(ii) of this revenue procedure under these facts.

Rev. Proc. 89-15, Table 2

Example of application of the mid-quarter convention in a short taxable year of 1 month.

| Quarter | Arithmetic Mid-point of the Quarter | Deemed Placed-in-Service Date |
|---|---|---|
| 1. December 1 to December 8, 1988 | December 5, 1988 | Beginning of December |
| 2. December 9 to December 15, 1988 | December 12, 1988 | Beginning of December |
| 3. December 16 to December 23, 1988 | December 20, 1988 | Middle of December |
| 4. December 24 to December 31, 1988 | December 28, 1988 | Middle of December |

.03 Computation--Allocation Method.

Example (1)--Initial Short Taxable Year.

FACTS. Assume the same facts as in section 5.01, above. In addition, assume that the property X placed in service during the taxable year was 5-year property with a cost basis of $100 and that X made no elections under section 168 of the Code.

ANALYSIS.

(1) Applicable recovery period. Under section 168(c) of the Code, the applicable recovery period for 5-year property is 5 years. The recovery period begins August 1, 1988, the date the property is deemed placed in service under section 168(d). Assuming that X does not retire the property before January 1, 1994, the recovery period ends July 31, 1993.

(2) Applicable depreciation method. Under section 168(b)(1) of the Code, the applicable depreciation method for X's 5-year property is the 200 percent declining balance method, switching to the straight line method for the first taxable year in which using the straight line method produces a larger depreciation allowance. The applicable depreciation rate for the property is 40 percent, that is, 200 percent divided by 5, the number of years in the recovery period. See section 6.04 of Rev. Proc. 87-57.

(3) First taxable year in the recovery period. For its taxable year ending December 31, 1988, X is entitled to 5 months of depreciation. The depreciation allowance is calculated by applying the applicable depreciation rate (40 percent) to the basis of the property ($100) and then multiplying the product by a fraction, the numerator of which is the number of months the property is deemed in service during the taxable year (5) and the denominator of which is 12. Thus, the depreciation allowance for the 1988 short taxable year is $16.67.

(4) Depreciation allowances for subsequent taxable years. Assume that X has no other short taxable years during the recovery period. For the taxable year beginning January 1, 1989, and ending December

31, 1989, X is entitled to 12 months of depreciation for the property. A recovery year for the property extends from August 1 to July 31. Seven months of the first recovery year and 5 months of the second recovery year fall within X's 1989 taxable year. The depreciation allowance for X's 1989 taxable year is the sum of (1) the depreciation attributable to the first recovery year times 7/12 and (2) the depreciation attributable to the second recovery year times 5/12; that is, 40 percent times $100 times 7/12, plus 40 percent times $60 times 5/12, equals $33.33. For the remaining portion of the applicable recovery period, X calculates its depreciation allowances under the declining balance method as shown in Table 3.

(5) Switch to straight line method. To determine the taxable year to switch to the straight line method, for each taxable year X must compare the depreciation allowance calculated under the declining balance method with the depreciation allowance calculated under the straight line method. See section 6.06 of Rev. Proc. 87-57.

For the taxable year beginning August 1, 1988, and ending December 31, 1988, the applicable depreciation rate under the straight line method, taking into account the 5-year recovery period, is 20 percent (1 divided by 5). This results in a depreciation allowance of $8.33 (20 percent times $100 times 5/12). Because the depreciation allowance calculated under the declining balance method produces a larger allowance ($16.67), X does not use the straight line method for taxable year 1988.

For the taxable year beginning January 1, 1989, and ending December 31, 1989, the applicable depreciation rate under the straight line method, taking into account the 4 years and 7 months remaining in the recovery period, is 21.82 percent [1 divided by (4 plus 7/12)]. This results in a depreciation allowance of $18.18 (21.82 percent times $83.33). Because the depreciation allowance calculated under the declining balance method produces a larger allowance ($33.33), X does not switch to the straight line method for taxable year 1989.

Table 3 shows, for comparison purposes, the depreciation allowances calculated under the straight line method if X switches from the 200 percent declining balance method to the straight line method in the taxable year identified.

The taxable year beginning January 1, 1992, and ending December 31, 1992, is the first taxable year in which the straight line method produces a depreciation allowance larger than the declining balance method. Thus, X switches to the straight line method for taxable year 1992. For that taxable year, X is entitled to a depreciation deduction of $11.37. Under the straight line method, the applicable depreciation rate for the taxable year in which the recovery period ends is 100 percent. Thus, for the taxable year ending December 31, 1993, X is entitled to a depreciation deduction of $6.63; this represents the remaining unrecovered basis in the property as of the beginning of the taxable year.

Rev. Proc. 89-15, Table 3

Computation of the Depreciation Allowance

Allocation Method--Declining Balance

| Taxable year | | Depreciation Allowance |
|---|---|---|
| 1988 | | [40% x $100.00 x 5/12] = $16.67 |
| 1989 | [40% x $100.00 x 7/12] | + [40% x $ 60.00 x 5/12] = $33.33 |
| 1990 | [40% x $ 60.00 x 7/12] | + [40% x $ 36.00 x 5/12] = $20.00 |
| 1991 | [40% x $ 36.00 x 7/12] | + [40% x $ 21.60 x 5/12] = $12.00 |
| 1992 | [40% x $ 21.60 x 7/12] | + [40% x $ 12.96 x 5/12] = $ 7.20 |
| 1993 | | [40% x $ 12.96 x 7/12] = $ 3.02 |

Determination of the Year of Switch to the Straight Line Method
(compare depreciation allowances)

| Taxable Year | Basis Adjusted for Depreciation Allowable | x | Straight Line Rate | x | Short year adjustment | = | Depreciation Allowance |
|---|---|---|---|---|---|---|---|
| 1988 | $ 100.00 | | 1/5 | | 5/12 | | $ 8.33 |
| 1989 | $ 83.33 | | 1/(4 + 7/12) | | 12/12 | | $18.18 |
| 1990 | $ 50.00 | | 1/(3 + 7/12) | | 12/12 | | $13.95 |
| 1991 | $ 30.00 | | 1/(2 + 7/12) | | 12/12 | | $11.61 |
| 1992 | $ 18.00 | | 1/(1 + 7/12) | | 12/12 | | $11.37 |
| 1993 | $ 6.63 | | 1 | | 12/12 | | $ 6.63 |

Example (2)--Subsequent short taxable years.

FACTS. Corporation Y, a calendar year taxpayer, incorporated and began business on May 1, 1987. On that date, Y placed in service a 5-year property acquired for $100. At the close of business on June 30, 1988, all of the stock of Y was acquired by Corporation Z, a fiscal year taxpayer with a June 30 year end. Y and Z elected in accordance with section 1501 of the Code to file a consolidated return.

ANALYSIS. When a taxpayer has a short taxable year other than the first taxable year in the recovery period, the depreciation allowance for that short taxable year must account for the difference between recovery years and taxable years.

Y has a short taxable year from May 1, 1987, to December 31, 1987. The property is treated as placed in service on September 1, 1987, the mid-point of Y's first taxable year. For the first taxable year in the recovery period, Y calculates its depreciation allowance in the manner described in section 5.03(3) above. Thus, for the taxable year ending December 31, 1987, Y is entitled to 4 months of depreciation. The depreciation allowance is calculated under the declining balance method by determining the amount of depreciation attributable to the first recovery year that is allocable to Y's first taxable year. Because the first recovery year runs from September 1, 1987 to August 31, 1988, 4 months of depreciation attributable to the first recovery year is allocable to the taxable year ending December 31, 1987. Thus, Y's depreciation allowance for the taxable year is $13.33 (40 percent times $100 times 4/12).

Because of Y's acquisition by Z, and Y and Z's election to file a consolidated return, Y's second taxable year ending June 30, 1988, is also a short taxable year. For the taxable year beginning January 1, 1988, and ending June 30, 1988, Y is entitled to 6 months of depreciation. Thus, Y's depreciation allowance for the taxable year ending June 1988, is $20 (40 percent times $100 times 6/12). Two months of depreciation attributable to the first recovery year is allocable to the 12-month taxable year beginning July 1, 1989. In addition, 10 months of depreciation attributable to the second recovery year is allocable to that taxable year. Thus, Y's depreciation allowance for the taxable year beginning July 1, 1989, is $26.67

Example (3)--Disposition before the end of the recovery period.

FACTS. Assume the same facts as in section 5.01 above, except that X disposes of the property on December 28, 1989.

ANALYSIS. When a taxpayer disposes of depreciable property before the end of the recovery period, the depreciation allowance for the taxable year of disposition must reflect the premature end of the recovery period. Because the half-year convention applies to this property, the property is deemed disposed of on July 1, 1989, the mid-point of X's second taxable year. For this taxable year, X is entitled to 6 months of depreciation for the property. Because the first recovery year extends from August 1, 1988, to July 31, 1989, 6 months of depreciation attributable to the first recovery year is allocable to the period during the second taxable year that the property was deemed in service. Thus, X’s depreciation allowance for the second taxable year is $20 (40 percent times $100 times 6/12).

.04 Computation--Simplified Method. The simplified method for calculating depreciation allowances is illustrated below. In most cases, the allocation method and the simplified method result in the same depreciation allowances. However, if prior to the switch to the straight line method (but after the first taxable year) the taxpayer has a short taxable year or disposes of the property, the depreciation allowance under the simplified method for that year will be less than under the allocation method.

Example (1)--Initial Short Taxable Year.

FACTS. Assume the same facts as in section 5.03 Example (1) above.

ANALYSIS.

(1) First taxable year in the recovery period. Under the simplified method, the depreciation allowance for the first taxable year in the recovery period is calculated in the same manner as under the allocation method. See section 5.03 Example (1) above.

(2) Depreciation allowances for subsequent taxable years. In lieu of allocating a portion of the depreciation attributable to the first recovery year and a portion of the depreciation attributable to the second recovery year to the taxable year beginning January 1, 1989, and ending December 31, 1989 (see section 5.03(4)), X may calculate its depreciation allowance under the declining balance method by applying the applicable depreciation rate (40 percent) to the unrecovered basis of the property as of the beginning of the taxable year ($83.33). Thus, X’s depreciation allowance for its 1989 taxable year is $33.33. For the remaining portion of the applicable recovery period, X may calculate its depreciation allowances under the declining balance method as shown in Table 4.

Rev. Proc. 89-15, Table 4
Computation of the Depreciation Allowances Under
the Simplified Method-Declining Balance

| Taxable year | Depreciation Allowance |
|---|---|
| 1988 | [40% x $100.00 x 5/12] = $16.67 |
| 1989 | 40% x $83.33 = $33.33 |
| 1990 | 40% x $50.00 = $20.00 |
| 1991 | 40% x $30.00 = $12.00 |
| 1992 | 40% x $18.00 = $ 7.20 |
| 1993 | [40% x $10.80 x 7/12] = $ 2.52 |

Determination of the Year of Switch to the Straight Line Method
(compare depreciation allowances)

| Taxable Year | Basis Adjusted for Depreciation Allowable | x Straight Line Rate | Short year x adjustment | = Depreciation Allowance |
|---|---|---|---|---|
| 1988 | $ 100.00 | 1/5 | 5/12 | $ 8.33 |
| 1989 | $ 83.33 | 1/(4 + 7/12) | 12/12 | $18.18 |
| 1990 | $ 50.00 | 1/(3 + 7/12) | 12/12 | $13.95 |

| | | | | |
|---|---|---|---|---|
| 1991 | $ 30.00 | 1/(2 + 7/12) | 12/12 | $11.61 |
| 1992 | $ 18.00 | 1/(1 + 7/12) | 12/12 | $11.37 |
| 1993 | $ 6.63 | 1 | 12/12 | $ 6.63 |

(3) Switch to straight line method. The taxable year X switches to the straight line method is determined as provided in section 5.03 Example (1) above.

Example (2)--Subsequent short taxable years.

FACTS. Assume the same facts as in section 5.03 Example (2) above, except that Y uses the simplified method described in section 4.03(2), above.

ANALYSIS. For the first taxable year in the recovery period, Y calculates its depreciation allowance in the manner described in section 5.03. Thus, its depreciation allowance for the taxable year ending December 31, 1987, is $13.33.

Because of Y’s acquisition by Z, and Y and Z’s election to file a consolidated return, Y’s second taxable year ending June 30, 1988, is also a short taxable year. For this short taxable year, Y calculates its depreciation allowance by multiplying the unrecovered basis of the property as of the beginning of the taxable year ($86.67) by the applicable depreciation rate (40 percent), and then multiplying the product by a fraction, the numerator of which is the number of months and fractions of months in the taxable year (6) and the denominator of which is 12. Thus, under the simplified method, Y’s depreciation allowance for the second short taxable year in the recovery period is $17.34; that is, $86.67 times 40 percent times (6/12).

Example (3)--Disposition before the end of the recovery period.

FACTS. Assume the same facts as in sections 5.01 and 5.03 Example (3) above, except that X uses the simplified method described in section 4.03(2), above.

ANALYSIS. For the first taxable year in the recovery period, X calculates its depreciation allowance in the manner described in section 5.03 Example (1); thus, its depreciation allowance for the taxable year ending December 31, 1988, is $16.67. The half-year convention applies when X disposes of the property in the second taxable year. Under the simplified method, X calculates its depreciation allowance by multiplying the unrecovered basis of the property at the beginning of the taxable year ($83.33) by the applicable depreciation rate (40 percent), and then multiplying the product by 6/12. Thus, under the simplified method, X’s depreciation allowance for the second taxable year in the recovery period is $16.67.

SEC. 6. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 87-57 is amplified and clarified.

SEC. 7. EFFECTIVE DATE

This revenue procedure is effective for property and taxable years subject to section 168 of the Code as amended by section 201 of the Tax Reform Act of 1986, 1986-3 (Vol. 1) C.B. 38. However, for property subject to the half-year or mid-quarter convention that was placed in service or disposed of during a short taxable year for which a return has been filed, see section 4.05 above.

DRAFTING INFORMATION

The principal author of this revenue procedure is Lisa J. Shuman of the Office of the Assistant Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue procedure contact Ms. Shuman on (202) 566-4840 (not a toll-free call).

1 See section 203(d) of the Tax Reform Act of 1986, 1986-3 C.B. (Vol. 1) 63, as amended by section 1002(c) of the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3358, for the treatment of transition rule property under section 168(d)(3) of the Code.

2 However, see section 168(i)(4) with respect to general asset accounts.