



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

OFFICE OF  
CHIEF COUNSEL

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June 1, 2000

The Honorable James T. Walsh  
Member, U.S. House of Representatives  
P.O. Box 7306  
Syracuse, NY 13261

Attention: Mary Beth Carmen

Dear Congressman Walsh:

This letter is in response to your inquiry to Floyd Williams, National Director for Legislative Affairs, Internal Revenue Service, dated April 20, 2000, on behalf of your constituent, [REDACTED].

Enclosed, as you requested, is a copy of our letter to [REDACTED]. If you have any questions, please contact me at (202) 622-3110.

Sincerely,

Paul F. Kugler

PAUL F. KUGLER  
Assistant Chief Counsel  
(Passthroughs and Special Industries)

Enclosure



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Dear [REDACTED]:

This letter is in response to your inquiry dated April 19, 2000, which was forwarded to the National Director of Legislative Affairs, Internal Revenue Service, from the Syracuse office of Congressman James T. Walsh. Your letter refers to letters dated November 1, 1999, and October 9, 1999, that raised questions regarding the application of certain sections of the Internal Revenue Code to specific facts related to the retail operation of a quilt shop business.

You asked about (1) section 168, relating to the accelerated cost recovery system (depreciation of business assets); (2) section 195, relating to start-up expenditures for a business; and (3) section 280A, relating to the deduction of expenses for the business use of a home. The questions you raised in your letters are not factually developed. For us to respond to your specific questions, you would have to submit a request for a private letter following the requirements of section 8 of Revenue Procedure 2000-1, 2000-1 I.R.B. 4. However, we can provide some general information that we hope is helpful. In addition, we are enclosing Rev. Proc. 2000-1; Publication 535, *Business Expenses*; Publication 587, *Business Use of Your Home*; Instructions for Form 8829, *Expenses for Business Use of Your Home*; and Publication 946, *How To Depreciate Property*, for your reference because we believe the general information they provide can be applied to the specific facts of your situation.

#### Private Letter Ruling

Rev. Proc. 2000-1 provides the general procedures the IRS follows in issuing rulings and the instructions for submitting ruling requests. Taxpayers are required by statute to pay user fees for letter rulings. Under section 15 of Rev. Proc. 2000-1, the user fee must accompany the request in order to be processed by the IRS. In general, the user fee for private letter rulings is \$5,000. However, for a request involving a business-related tax issue from a taxpayer with a gross income of less than \$1 million, the fee is \$500. See Appendix A of Rev. Proc. 2000-1.

## Depreciation of Business Assets

For section 168 of the Code, Publication 946, on pages 4-8, lists tangible assets that can be depreciated and those that cannot be depreciated and provides guidance on how to calculate the depreciation deduction for depreciable tangible assets purchased after the start-up of the business.

## Start-up Expenditures for a Business

For the amortization of security deposit payments as start-up expenditures, section 195(c)(1)(B) of the Code provides the rule that the amounts are start-up expenditures (i.e., start-up costs) only if they would be allowed as a deduction in an ongoing business (but paid or incurred before active business begins). On page 44 of Publication 535, under the heading **Business Start-Up Costs**, the rule under section 195(c)(1)(B) relating to the conditions under which a start-up cost is amortizable is discussed.

## Instructions for Completing Form 8829

For your question regarding lines 38 and 40 of Form 8829, Expenses for Business Use of Your Home, and the treatment of additions or improvements placed in service subsequent to the year the business use of a home began, Publication 587 and Instructions for Form 8829 provide guidance.

Part III of Form 8829, the "attached statement" referred to in the Form 8829 instructions, and Form 4562 all pertain to basis and depreciation. Form 8829 and the Part III instructions direct the taxpayer to enter on Line 35, the lesser of the home's adjusted basis or the fair market value of the home at the time it first is used for a business purpose. On Line 36, the taxpayer enters the value of the land included in Line 35, and on Line 37 enters the amount that results from subtracting Line 36 from Line 35. (The value of the land is subtracted out because land is not a wasting asset and thus is not depreciable.)

The Line 37 amount, which is the business basis of the building, is then multiplied by the percentage of the building used for business purposes, with the result being entered on Line 38. On Line 39, the taxpayer enters the depreciation percentage indicated by the instructions. The taxpayer multiplies Line 38 by Line 39 and, if there have been no additions or improvements made to the residence after its business use began, the taxpayer enters the resulting amount as "allowable depreciation" on Lines 40 and 28.

The amounts originally entered on Lines 35 through 37 of Form 8829 generally will remain the same during all subsequent years in which the residence is being used for business purposes, regardless of whether additions or improvements are later made to the residence. Line 38 will change in any year in which the taxpayer increases or decreases the percentage of taxpayer's home used for business, and Line 39 (the depreciation percentage) ordinarily is slightly larger in later years than in the year the business use begins. However, the method for making the Line 40 computation will be

modified in the manner explained below if: (1) taxpayer makes additions or improvements to the residence in a later year (or years), and (2) the taxpayer continues in those later years to use the residence for business purposes.

#### Modification in the Method of Computing Depreciation on Home Improvements

The modification in the method of computing Line 40 reflects the fact that for tax purposes, depreciation is claimed on an asset-by-asset basis, rather than on an aggregate basis. A taxpayer who makes an improvement to the home and who uses the home for business purposes is entitled to claim depreciation on the improvement, but the improvement must be depreciated separately and according to its own time of placement in service. Thus, the taxpayer does not increase the basis of the residence by the amount spent on the improvement and claim depreciation on that increased (or aggregated) basis. Instead, the taxpayer computes two separate amounts of depreciation -- one on the residence and the other on the improvement -- and adds those amounts together.

As noted earlier, if no subsequent improvements are made, the Line 40 computation ends with the Line 38 amount being multiplied by the Line 39 amount. However, if the taxpayer made additions or improvements to the residence after it first began being used for business, the Line 40 instructions for 1999 direct the taxpayer to a 2-column, 7-row table, from which the taxpayer can obtain the business depreciation percentage applicable to the improvement. The taxpayer is asked to: use the table to compute the amount of depreciation allowable on the improvement, add that amount to the amount of allowable depreciation on the residence (calculated by the Lines 38 and 39 multiplication), enter the total of those amounts on Line 40, and attach a statement to the Form 8829 showing the computations just described.

The IRS asks that the schedule be attached to the Form 8829 for the year in which the improvement is made and for all later years for which depreciation is being claimed. The purpose of the schedule is to show how and why the amount entered on Line 40 differs from the amount that results from the Lines 38 and 39 multiplication. Absent the schedule, the Line 40 amount will appear to be a math error, whereas with the schedule the seeming discrepancy is explained.

#### Using a Residence to Conduct Business as a Sole Proprietor

When a taxpayer uses taxpayer's residence to conduct business as a sole proprietor, the taxpayer should file both Schedule C and Form 8829 for any year in which the taxpayer is doing business as a sole proprietor and claiming expenses for the business use of the home. The Form 4562 should be filed for the year in which the taxpayer first begins using the home for business purposes and should also be filed for any subsequent year during which the taxpayer makes improvements and claims expenses for the business use of taxpayer's home. However, the Form 4562 need not be filed in other years.

Form 4562 Depreciation should not be shown on Schedule C

You also asked in your letter how to subtract depreciation entered on Form 4562 to prevent that depreciation from being entered on Schedule C, Line 13. You are correct that the Form 4562 depreciation should not be reflected on Schedule C, Line 13, because that line expressly pertains only to depreciation expenses that are not related to the business use of the home. The method for ensuring the Form 4562 amount is not reflected on Line 13, however, is not to subtract the Form 4562 amount from Line 13 of the Schedule C. Rather, as the Form 8829 instructions indicate, the Form 4562 amount should simply not be included on Line 13 of Schedule C.

This letter has called your attention to certain general principles of tax law. It is intended for informational purposes only and does not constitute a ruling. See sections 2.01 and 2.04 of Rev. Proc. 2000-1. We hope the materials enclosed will be helpful to you. If you should have any additional questions, please contact our office at (202) 622-3110.

At the request of Congressman James T. Walsh, we are sending a copy of this letter to his Syracuse, NY office.

Sincerely yours,

Paul F. Kugler

PAUL F. KUGLER  
Assistant Chief Counsel  
(Passthroughs and Special Industries)

Enclosures (5)

cc: The Honorable James T. Walsh