DEPRECIATION: USE IT OR LOSE IT MISTER!

THE "abcs" of Depreciation, and what you should know…

Issue 10 By Milan Madhani, CPA & Vimal Madhani, MST, EA November 2nd, 2011

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What is Depreciation...and Why Should I care?

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For those of you who need a more technical explanation, here is what the IRS says (http://www.irs.gov/businesses/small/article/0,,id=137026,00.html). An even simpler explanation is here: http://www.irs.gov/taxtopics/tc704.html For a thorough reading for you overachievers, see Pub 946 http://www.irs.gov/pub/irs-pdf/p946.pdf

For the rest of us, I will start with the basics. If you have ever bought a car, a washing machine, dishwasher, lawnmower, furnace, computer, real estate, or even a hairdryer, there are a few commonalities in all of them. One, most of us cannot do without them; two, they have an initial cost; three, they get older and do not work as well over time; and four, they eventually become outdated and not as fast, efficient and effective as the newer models of their kind. Now, many of us buy a great deal of the above products and the like for our everyday personal use. However, it is when we employ those things in our businesses is when we must be aware of deductions for all of the above.The IRS recognizes these facts of life, and allows taxpayers an expense to reflect all of that. Depreciation, according to the IRS, is an allowance for the wear and tear, deterioration, or obsolescence of the property. Our definition of it is that it is essentially an expense for which a tax deduction can be taken for part or all of the cost of the asset, thereby arriving at lower taxable income and lower income tax liability. So long as you own it is yours to depreciate against taxable income (for the life of the property up to its cost or value as of the date of initial use) even if you bought it through financing. (FYI: You cannot depreciate land).

Taxable Income (IRS rules): Income tax is assessed on final, bottom line net profit from your business; therefore, it makes sense that the less your profit is, the lesser the income tax that would be assessed on it, from federal, state & local sources. Depreciation and amortization are two non-cash expenses afforded to all taxpayers which assist in arriving at that lower taxable income. Even if you are a sole proprietor, that computer you bought lowers your self-employment income, thereby lowering your taxable income and income tax liability because that computer is depreciable. For most business expenditures, deductions are taken in the year in which incurred. You go to a home improvement store, buy supplies on your credit card or via cash / check, and you take the supplies to your business or home -- you essentially just incurred an expense for which a matching income tax deduction is allowed. Supplies are allowed to be "expensed." That's relatively straightforward. However, it is when you purchase equipment & property is when, the IRS says, you may ONLY deduct a portion of the cost in the year in which you started using it (assuming it's used in your business). Assuming the asset (property and/or equipment) has a useful life of more than a year, you would be required, in most instances, to "spread out" the cost of that particular asset over its useful life, known as its "depreciable life." That is a unique way for you to "recover" the cost of the asset(s) you may have purchased and placed in service in any one year. For example, a copy machine costing $15,000, which has an IRS depreciable life of 5 years, would be depreciated every year for $3,000, until the full $15,000 cost is used up over the prescribed period. Taxable income would be lowered by that $3,000 every year, thereby offering a lower federal and state tax liability (caveat emptor, states may have different depreciable lives

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and rules for when and how much you may depreciate). Different rules apply for and when you would sell or close down your business or even trade in your asset for a new one; therefore, for simplicity's sake, we will just deal with simple examples here in this e-newsletter.

"179" Depreciation: Sometimes, the IRS says, you may not have to first spread out the cost of your equipment or property purchase out over its useful life and can go ahead and first decide to subtract ALL or MOST of the cost (or value) of asset directly against your taxable income in the very year you put it into service (Depreciation ALWAYS starts from the year of service, and not necessarily the year of purchase, unless they are one and the same). This is called "electing 179 depreciation", named after the Code section dealing with this topic, because one may CHOOSE to use this depreciation amount or save it for other depreciable assets placed into service in that year. The maximum amount of depreciation you may deduct against taxable income on your tax return is limited to $500,000 (2010 amount); however this amount is reduced by the amount by which the cost of the property exceeds $2,000,000. This means if you bought ten refrigerators for your trucking business worth $100,000 each, the max you can "179" is $500,000 and the rest of the refrigerators (5), would have to be depreciated according to a depreciation life the IRS uses, called MACRS, discussed later here. (So the rest of refrigerators would be depreciated as follows: $100,000 x (5) / 7 years = $71,429 per year).

Bonus Depreciation: This is usually 50% or 100% of the cost of the asset deducted in the year of service (depending on if it was 2009 or 2010). Imagine you bought a deluxe, gourmet, vintage soda machine for your workplace worth $50,000. You can immediately deduct the special bonus depreciation cost of it, AFTER, you have deducted any 179 depreciation. Let's say you have already used up your 179 depreciation on your other equipment (your refrigerators from the above example); therefore, you can essentially write off either 50% or 100% of the $50,000 cost of the soda machine, depending on when it was placed in service. If you placed it in service in 2009, that's a $25,000 deduction taken against your income. The balance would then be depreciated straight-line or according to MACRS. The same goes for if it's software (off-the-shelf, not developed), qualified leasehold improvement property (common areas of your real estate holding), and other tangible personal property having useful life of 20 years or less. Bonus depreciation is also called "special" depreciation; just remember, that each asset is special and gets a bonus and you will remember this.

MACRS: Imagine that you took the 179 depreciation and the bonus depreciation for a specific asset, and the IRS says you can STILL take an extra deduction for it's remainder useful life in the year of service (179 and bonus "special" depreciation is only allowed in the first year)! That's like three different depreciation deductions in the first year of service! (No, Christmas does not come early and the IRS is not being nice - the next paragraph shows why). The subsequent years of ownership of the asset only allow you the useful straight line depreciation amounts (or MACRS amounts). The MACRS table (Modified Accelerated Cost Recovery System) shows the amounts you could potentially depreciate for that specific type of asset. Essentially, the IRS allows a faster recovery time (meaning a higher depreciation amount over the simple straight-line depreciation according to special MACRS tables). It is not as quite straight forward as a mathematical useful life calculation of depreciation through the straight-line we described above (the copy machine example); however, if you are using software to complete your returns, rest-assured that so long as you listed the "type" of asset you have or placed in service (house, vehicle, machinery, etc.), when you placed it in service, the cost or value of it at the time of service, then the software would do its job by properly calculating MACRS depreciation only after it would have prompted you to see if you desired to also take the 179 and/or bonus depreciation amounts (if available to you).

Use it or Lose It: One thing that we thought we would make aware to most people and business filers about depreciation is that it is not a permanent fix; whether it's your car, copy machine, your gourmet soda machine, refrigerator, or any other equipment or property you might be depreciating, the Code is pretty clear in two respects. For one thing, the asset must be used in your business. Secondly, depreciation is not for free. It is, rather, an "interest-free" loan. The IRS says that in most instances of you either trading in or selling the asset for which you were allowed depreciation, the Code requires you to *give back* that depreciation by reducing the cost of the asset (or fair market value at time of service) before you calculate your taxable gain upon the sale

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or trade-in of the asset. This reduction in the asset cost/value is done so that you comfortably arrive at a number known as "adjusted basis".

So take for example, an investment property you are contemplating upon selling. When you go to sell it, you would be shocked to discover that you had to add back the depreciation you *could have taken* into the sales price! Section 1011(a), 1012, 1016(a)(2). This is known as depreciation recapture on Section 1250 Property (as investment real estate property is known). A rather subtle (or not so subtle, however you look at it) inequity in the Code, lying like a snake in the grass looking to bite you once you come across it. If you sell it for $220,000, but it costed you $100,000, but to which you made repairs worth $40,000, your adjusted basis is now $140,000 (the initial cost plus the repairs). The depreciation recapture which you would potentially have to factor into your taxable gain at the time of sale would reflect the lesser of the amount allowed or allowable (for that type of property) to you during that period of ownership. If you did not take any depreciation, but could have taken at least $35,636, ($140,000 / 27.5 years x 7 years) then that number could very well be factored into your gain when and if you either sold or traded in that property for another one. Therefore, your gain would NOT be only $80,000, but rather, $115,636 (you must add the depreciation allowed to you of $35,636 even though you did not take it). A "recapture" of this kind from Sec 1250 property is subject to ordinary income tax, and not a capital gains maximum tax rate of 15%. The point is, all depreciable property, your machinery, patents, copyrights,subscription lists, employment contracts, covenants not to compete, media rights to films, video tapes and sound recordings, even GOODWILL, etc.) is subject to depreciation recapture, if you ever sell it or trade it in (assuming you used them in your business).

It basically boils down to the fact that the amount of depreciation allowable per the Code may still be subject to recapture and thus used to compute your overall gain on the sale of the property. Of course if the amount allowed and taken by you may have been lesser due to a unique situation during the time of ownership of the asset, then the recapture is not as potentially as high as the amount "allowable" per Code. This is because the "allowed or allowable" definitions and tests in Section 1016 and in the recapture provisions are mutually exclusive within IRC (Internal Revenue Code). As you can see, these things can be quite hairy and downright confusing, which leads us to the following point.

Bottomline: There are so many different rules, variations, "ins & outs" to the topic of depreciation, that it is a virtually gargantuan task to write and educate oneself about the topic of depreciation. For one thing, not only do states and localities have different rules about depreciation -- which can and do differ from the IRS's -- but rather our lawmakers are also constantly changing what qualifies for depreciation, how much, when, and how it can qualify. For another, there are things which totally defy the logic of everything we just went through above; for e.g., vehicles have their own special subsection for depreciation and how much they qualify for, contingent upon of all things, their weight. We could have a whole series of depreciation topics devoted to the type of asset, type of depreciation, type of businessowner and business, recapture amounts, and all the Code exceptions which would apply, and we would still not be halfway through with the entire discussion of depreciation. The bottomline is, *make sure you get the lowest bottomline net taxable income by maxing out all other available deductions, and then investigate your maximum allowable and available depreciation for that specific asset!* You can do this by using quality software and of course, an informed tax professional well-versed in IRS and state depreciation rules.

So talk to your tax preparer, adviser, or be somewhat familiar with the rules of depreciation via Publication 544, and you will not be caught off-guard during this tax season.

Happy reading!

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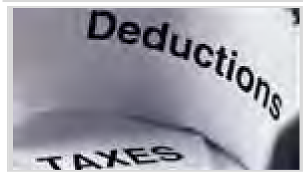

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