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A PRIMER ON DEPRECIATION

With few exceptions, most businesses have to deal with the issue of depreciation at one time or another. Whether it be in connection with office furniture and equipment, vehicles, computers, buildings, or livestock, to name a few, this type of tax write-off comes into play.

What is depreciation anyway? You probably know that it involves a tax write-off. But it started unofficially long before we had income taxes in this country. In a very shortened definition, depreciation is the calculated "wear and tear" of a business asset due to its use in the business. Some assets last longer than others. A building may last 40 years without major problems. An electric drill may only last five years before becoming useless. In effect, the useful life of the asset tends to vary according to its type and nature.

This is the original theory behind depreciation. It represents how much of the asset's value must be replaced (or saved up) each year to eventually replace it or restore it to proper working order. For a business, it is a form of a "reserve account." This is the recognition that the asset will last longer than one year, and therefore its cost should be allocated over a period of its useful life instead of just in the year in which it was placed into use.

Why is it important? For tax purposes, depreciation deductions help to offset some of your business taxable income, thus creating current year tax savings, and increasing your business cash flow. In addition, for future budget purposes, a working knowledge of depreciation deductions allows you to know how much money to reserve for future replacement purposes of assets being used in your business. So an overview of this common business deduction is definitely in order.

Qualifying Depreciable Property

For tax purposes, depreciation represents an allowable deduction of a portion of an asset used in a trade or business or for the production of income. To be depreciable, this property must meet three main tests, according to current 2000 rules:

It must have a "useful life" in excess of one year that is determinable. In effect, it has to have a relatively predictable time period in which to wear out, become obsolete, deplete its value, etc. Thus, antiques are usually not depreciable, but office equipment, and buildings are. It has to be used in a business or for the production of income. Generally speaking, to take depreciation deductions, you must show "incidents of ownership" of the asset: legal title, or responsibility to pay for its upkeep, taxes, etc. You can't usually depreciate someone else's property in other words.

There are two primary classifications of depreciable property: **tangible and intangible.**

Tangible property has physical substance; it can be touched, and seen. Within this category is a further division between tangible "personal" property, and "real" property. Real property is usually associated with realty–buildings, land(although land itself is not depreciable), improvements to such. Personal property is an asset such as a machine, furniture, equipment, etc.

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Intangible property is property that does not have true physical substance so it cannot be readily touched or seen. A patent right, customer goodwill, a non-compete covenant, customer lists, and copyrights–to name a few–fall into this category. While these intangible assets do not tend to wear out like a piece of machinery, in the eyes of the IRS they do have an obsolescence, or loss of value feature, thus they are allowed to be written-off as a depreciable expense.

Depreciable Basis

Once the property qualifies to be depreciated, the next step is in determining how much of it qualifies; that is, what is its "depreciable basis." For most qualifying assets, it is pretty straightforward: The depreciable basis is what you paid for the item, or its cost. Some adjustments to basis may be made if you then add to its cost (improvements to a building, for example). On the opposite side would be basis reductions for such events as a casualty loss, or a partial sale of part of the asset.

By the way, if you pay for the asset on a time payment plan, or if you charge it, your basis is still the total cost, not just what you paid out in cash for the current year. Thus, you may be able to charge a computer at the end of the year and still take a full depreciation deduction for it even if you haven't put out one single dollar yet.

However, there are a few instances where this basis calculation can be tricky. This occurs when you haven't actually bought the item, or when you have owned it personally, and then start using it for a business later on. In these cases, the basis to be used can vary. If you inherited the asset, for instance, the basis is usually the fair market value of the item at the time of death–not necessarily its original cost. So if you inherit a rental building from your grandfather, its depreciable basis may be higher or lower than the original cost depending on whether or not it had appreciated over the time your grandfather owned it.

If you received the asset as a gift, the basis determination is usually the LESSER of the original cost of the asset OR its fair market value when it was given to you. An asset acquired involving a trade-in (like a vehicle) of another asset requires adjusting its basis to account for the value of the asset traded in. If the asset traded in had already been depreciated, the new item's depreciable basis usually is its cost less the trade-in value obtained.

Many times you will convert an asset you already own into business use. As an example, you may have owned a computer that you were using personally before you started your business. Then you begin using the computer for the business. The same may apply to a car. In these cases, where you are changing the asset use to business purposes, its basis for this depreciation is usually calculated the same as a gift – it is the lesser of the adjusted cost basis or its fair market value at the time of conversion to business use.

When Depreciation Is Claimed

The depreciable asset becomes qualified when it is placed into business use or for the production of income–not necessarily when it was originally bought. The IRS considers it being placed into use "when it is ready and available for a specific use...."

This can create some tax planning opportunities as to the timing of taking depreciation to offset some of your business income. The key is to plan exactly when the asset is "ready and available" to start the qualifying depreciation calculation.

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Important note: Depreciation of a business asset is not really an election on your part. The IRS position is clear. If it was supposed to be depreciated, and it wasn't, the IRS still makes you take that depreciation amount into account when you dispose of the item. This could result in more net taxes owed.

Depreciation Recovery Periods And Methods

As was mentioned earlier, depreciable assets have different useful life periods – some last longer than others. This is the basis for the IRS use of different periods over which to calculate the depreciation amounts. The shorter the allowable useful life, the larger the depreciation percentage that can be taken per year.

These useful life periods establish the number of years over which the basis of the property is depreciated or recovered. Accordingly, the 2000 IRS guidelines for these recovery periods are:

3-year property: Tractor units, certain racehorses, other horses over 12 years old when placed into service.

5-year property: Automobiles, trucks, other vehicles, computers, office machinery, various research & development property.

7-year property: Office furniture, fixtures, etc., certain agricultural and horticultural structures or any property that doesn't readily fall into another class life.

10-year property: Water transportation such as vessels, barges, tugs, certain fruit/nut bearing trees and vines, certain single purpose agricultural or horticultural structures.

15-year property: Various depreciable improvements made to land such as fences, roads, shrubs, bridges, etc.

15-year amortization: For intangible assets acquired after 8/10/93, the capitalized costs are written-off. Items such as goodwill, patents, customer or supplier based intangibles, franchise or trade name costs, non-compete covenants, copyrights, etc.

20-year property: Farm buildings, municipal sewers.

Residential Rental Property: Realty property that is a rental structure in which 80% or more of the gross rental income (or fair rental value) is for dwelling purposes. This recovery period becomes 27.5 years.

Nonresidential Real Property: Normally associated with commercial use purposes such as buildings. The recovery period varies from 31.5 to 39 years depending on when the realty was placed into use.

Start-Up Costs: These are initial costs incurred in finding, and starting up a business such as incorporation fees, research expenses, investigative costs, etc. The write-off period is 60 months from the start of business.

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Depreciation Methods

For most tangible depreciable assets acquired in the current 2000 year, the IRS approved method is the Modified Accelerated Cost Recovery System(MACRS). It is a cross between an accelerated and straight-line depreciation calculation. Therefore, the majority of depreciation calculations now must use this method.

However, there are some elections out of this method, and there are some depreciable assets that don't qualify for MACRS. In that case, other methods may have to be used, such as certain straight-line methods, unit-of-production calculations, amortization periods, or others that the IRS would deem reasonable. Similarly, before the IRS instituted the MACRS rules in 1986, there were numerous other methods including ACRS, and declining balance calculations. The list was practically endless.

Nevertheless, all the depreciation methods attempt to do the same thing: create a consistent methodology for writing-off a portion of the asset in question over its useful life. The main difference among all of them is the amount per year that can be taken. The accelerated methods tend to take more depreciation in the early years, and less later on. A straight-line method tends to average the depreciation deduction equally over the useful life. Bottom line, however, is that if you keep the asset in business use for its entire calculated useful life, all the methods tend to equal out.

The tax planning opportunities lie in trying to coordinate the maximum amount of depreciation deduction with tax bracket changes to get the most use out of the deduction. So if your tax bracket were going to be higher in the earlier years of a depreciable asset's life, an accelerated depreciation method may be better than a straight line. Or vice versa if your tax bracket were to be higher in the later years.

IRS Conventions: Under MACRS rules, there are IRS rules as to when the depreciation deductions can begin. Normally, the half-year convention is allowed for property other than rental and nonresidential real property. In the half-year convention, all property is deemed to be placed into service or disposed of at the midpoint of that tax year.

A complication arises in the situation where more than 40% of the total cost of depreciable assets is placed into service during the last 3 months of the tax year. In that case, the Mid-Quarter convention must be used. The disadvantage here is that you are allowed substantially less depreciation deductions for the first year if you must use the Mid-quarter vs the Half-year convention.

So timing your tangible personal property purchases can make a difference in the first year's depreciation deduction. There is also a possible way around the negative effects of this Mid-quarter convention by using a Section 179 election to be discussed next.

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Special Section 179 Deduction

Along the lines of trying to use depreciation deductions for tax planning purposes, the IRS has a special provision related to tangible personal property used in a business in which you can elect to take an extra large chunk of depreciation deduction in the first year instead of over its remaining useful life. This is the so-called Section 179 election(which relates to the IRS code section provision).

Under the 1999 rules, you are able to elect to take up to $19,000 of upfront depreciation deductions if you qualify–even if you get these depreciable business assets on the last day of the tax year. As an example, if you bought a computer system for $18,000 on December 20, 1999, you could elect to write-off the entire cost on your 1999 tax return instead of depreciating it over 5 years. As you can surmise, this can be a significant last minute tax planning opportunity if it is handled correctly, and may be used to offset the effects of any IRS Mid-quarter convention limitations.

The main qualifying factors for this Section 179 election are as follows:

It must be tangible personal property used in a trade or business. Realty doesn't count, nor does any property used only for the production of income (like a rental property). It's only for a trade or business. You must use the item more than 50% for business use, and allocate the item's cost accordingly.

You must have taxable income from the "active conduct of any trade or business during the tax year in question." In other words, if your total business income from all sources for the year ends up as a net loss, then you cannot add to this current year loss by electing Section 179 depreciation expense.

This election is reduced dollar for dollar in the situation where you place into use more than $200,000 of tangible personal property. As an example, if you put $210,000 of machinery into use in 1999, then you could only take $9,000 worth of Section 179 depreciation expense($19,000 less the $10,000 in excess of $200,000 limit).

If you use this election, it means you are expensing more of the asset up-front, so there is less to depreciate in the future years. It is not an EXTRA amount of depreciation deduction you are being given. Rather, it is an accelerated amount you are taking in the beginning. From a tax savings analysis, it is a tax deferral technique as much as it is a tax savings technique.

Also, there are some so-called recapture rules which may come into play if you make this election and do not keep the asset in qualified business use for a designated time. In that case, a portion of the deduction taken may have to be recaptured–and reported as income in another year.

However, this election can reduce your current year taxes considerably, thus freeing up more cash for the business. It could also increase potential earned income credits for certain low income business filers; it can also help minimize IRS depreciation deduction limitations where the mid-quarter convention rules come into play.

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Conclusion

Depreciation is an important consideration for most businesses. With few exceptions it eventually comes into play. The proper timing of the depreciation deduction, choosing allowable depreciation methods, and potential disposition options can have a positive impact on your tax situation.

Maintaining adequate records for the individual assets in order to verify the depreciable cost basis, the date placed into service, and the date if taken out of service are quite significant. This can affect your potential tax liability, and can make a difference in the event of an audit.

The bottom line when it comes to depreciation deductions and tax planning is timing considerations. Proper planning as to when you place the qualifying depreciable asset into use, what depreciable methods can be used, and your current vs future tax brackets can help maximize the benefits for your business.

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