YEAR-END PLANNING - MAKING THE MOST OF QUICK WRITEOFFS FOR CAPITAL GOODS PURCHASES (PART II)

Depreciation deductions under Code Sec. 168 and expensing deductions under Code Sec. 179 are far more generous this year than they will be next year. In short, for those businesses confident enough to expand in these challenging economic times, now is a good time to buy machinery and equipment (and make expensing-eligible qualified real estate purchases). This is the second installment of multi-part *Hot Topic* on how businesses may be able to lock in accelerated deductions by buying qualifying assets this year and placing them in service before year-end. It examines the generous Code Sec. 179 expensing rules which apply this year but will be curtailed next year.

Part I examined the bonus first-year depreciation allowance - 100% for qualified assets placed in service this year, but declining to 50% for qualified assets placed in service next year. Part III in the series will examine the qualified real property expensing allowance ($250,000 limit) which applies for tax years beginning in 2010 and 2011.

- ***Making the Most of Generous Code Sec. 179 Expensing Limits for 2011***

  Under Code Sec. 179, a taxpayer, other than an estate, trust and certain noncorporate lessors, can elect to deduct as an expense, rather than to depreciate, up to a specified amount of the cost of new or used tangible personal property placed in service during the tax year in the taxpayer's trade or business (for 2010 and 2011, a limited amount of qualified real property also may be expensed). The maximum annual expensing amount generally is reduced dollar-for-dollar by the amount of Code Sec. 179 property placed in service during the tax year in excess of a specified investment ceiling. The amount eligible to be expensed for a tax year can't exceed the taxable income derived from the taxpayer's active conduct of a trade or business. Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding tax years.

- ***Extraordinarily high expensing limits for 2011***

  For tax years beginning in 2011 (as well as tax years beginning in 2010): (1) the dollar limitation on the expense deduction is $500,000; and (2) the investment-based reduction in the dollar limitation starts to take effect when property placed in service in a tax year exceeds $2,000,000 (beginning-of-phaseout amount). However, for tax years beginning in 2012, the dollar limitation will drop to $125,000 (indexed for inflation with 2006 as the base year), and the beginning-of-phaseout amount will drop to $500,000 (indexed for inflation with 2006 as the base year).

> **Observation:** Thanks to the generous limits that currently apply, virtually all small businesses and many medium sized businesses which don't have costly machinery and equipment needs will be able to use Code Sec. 179 expensing to write off much, if not all, of their capital goods outlays. For property placed in service in tax years beginning in 2011 (as well as 2010), the Code Sec. 179 deduction doesn't phase out completely until the cost of expensing-eligible property exceeds $2,500,000 ($2,000,000 (beginning-of-phaseout amount) + $500,000 (dollar limitation)).

There is no pro rata reduction of the Code Sec. 179 expensing deduction depending on the portion of the year the asset is held. If the deduction is allowable, the amount which may be expensed is the same regardless of when the property is acquired during the year.

> **Recommendation:** The fact that the expense deduction may be deducted in full regardless of how long the property is held during the year can be a potent tool for year-end tax planning. Thus, property acquired and placed in service in the last days of a tax year, rather than at the beginning of the following year, can result in a full expense deduction for the earlier year.

- ***Year-end move #1***

Where possible, taxpayers should factor the annual expensing limits for 2011 and 2012 into their annual equipment-purchase plans so as to maximize the writeoff for this year and the next.

> **Illustration 1:** During the first eleven months of 2011, ABC, a calendar-year corporation, bought and placed in service $400,000 of expensing-eligible property. It plans to buy an additional $200,000 of expensing-eligible property early next year. If it's feasible to do so from the business standpoint, ABC should consider accelerating $75,000 of next year's purchases into 2011 (and place the additional assets in service before year-end). This way, ABC will be able to fully expense its purchases (total of $475,000 for 2011 and $125,000 for 2012).

- ***Taxable income limit***

The Code Sec. 179 expensing deduction is limited to taxable income from any of the taxpayer's active trades or businesses. This means that the taxable income limit doesn't bar an expense deduction just because the particular business in which the property is used doesn't produce any net income. So long as the taxpayer has aggregate net income from all his trades or businesses, the deduction is allowed. In general, any amount that cannot be deducted because of the taxable income limit can be carried forward to later years until it is fully deducted.

- ***Year-end move #2***

Taxpayers should consider making the expense election even in a year where a less-than-full tax benefit is derived from the election because of the taxable income limit. This way, the taxpayer's right to carry the expensing deduction forward to other years is preserved.

> **Illustration 2:** In December of 2011, Widget Products, a calendar year business, buys and places in service $200,000 of qualified 5-year MACRS property subject to the half-year depreciation convention. The asset is used and thus isn't eligible for bonus depreciation. If Widget Products doesn't elect to expense any part of the $200,000, then under the half-year depreciation convention (and under the 200% declining balance method) it is entitled to a $40,000 depreciation deduction for this property for 2011 ($200,000 × .20 first year allowance). On the other hand, electing to expense the cost of the asset would reduce business taxable income by $200,000. Moreover, even if Widget Products does not have sufficient taxable income to absorb the entire expensing deduction in 2011, the full amount of the excess will be available to offset taxable income in 2012.

- ***Wages count for taxable income limit***

Wages, salaries, tips and other compensation earned by employees count for purposes of their Code Sec. 179 taxable income limit.

- ***Year-end move #3***

Employees who run a sideline business may be able to reduce their 2011 tax bill by buying business equipment they need before the end of this year rather than in 2012.

> **Illustration 3:** Jack is employed as a website designer and earns $70,000 a year. In September of 2011, he starts a wedding and portrait photo sideline business but will earn only around $2,000 from it this year. Jack is planning to buy $3,000 of high-end photo and computer equipment for his sideline business. If he buys and places the equipment in service this year, Jack can fully offset his $2,000 freelance income and $1,000 of his regular employment income.

- ***Investment-based phaseout of expensing***

As we've said, for 2011, the maximum amount that can be expensed under Code Sec. 179 is reduced dollar-for-dollar for eligible property placed in service during the tax year in excess of $2,000,000.

> **Illustration 4:** XYZ Corp is a calendar-year taxpayer. In 2011, it buys and places in service $2,200,000 of expensing-eligible used 5-year MACRS property.

XYZ may only expense $300,000 of its 2010 purchases [$500,000 expensing limit – ($2,200,000 purchases – $2,000,000 beginning-of-phaseout amount)] and must depreciate the $200,000 balance of its purchases over a period of years.

Caution: Amounts ineligible for expensing due to excess investments in expensing-eligible property can't be carried forward and expensed in a subsequent year. Rather, they can only be recovered through depreciation.

- ***Year-end move #4***

Businesses that are not equipment intensive enterprises should try to avoid buying and placing in service more than the ceiling amount of expensing-eligible property during the year, if it's possible from the business standpoint to defer additional purchases.

- ***What's eligible for expensing***

In general, property is eligible for Code Sec. 179 expensing if it is:

(1) tangible property which is Code Sec. 1245 property (generally, machinery and equipment), depreciated under the MACRS rules of Code Sec. 168 , regardless of its depreciation recovery period;

(2) for any tax year beginning in 2010 or 2011, up to $250,000 of qualified real property; and,

(3) if placed in service in a tax year beginning before 2013, off-the-shelf computer software.

Observation: There's no requirement the acquired property be new. Thus, taxpayers may claim expensing for otherwise eligible used property.

- ***Year-end move #5***

As a general rule, to maximize the tax benefit to be gained through expensing, a taxpayer should make the expensing election for eligible property with the longest recovery period.

Illustration 5: In 2011, ABZ, a calendar-year taxpayer, buys and places in service $500,000 of new 5-year MACRS property and $500,000 of new 7-year MACRS property. It doesn't purchase other property during the year and is subject to the half-year depreciation convention for 2011. If it elects to expense the 7-year property, ABZ can write off the balance of its purchases over the 5-year MACRS recovery period (effectively 6 years because of the half-year convention). By contrast, if it elects to expense the 5-year property, ABZ will have to write off the balance of its purchases over the 7-year MACRS recovery

period (effectively 8 years because of the half-year convention).

Observation: As we'll explain in the third and final installment of this article, the general rule about making the expensing election for eligible property with the longest recovery period may not hold true for 2010 and 2011 where the taxpayer has purchased qualified real property eligible for expensing under Code Sec. 179.

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