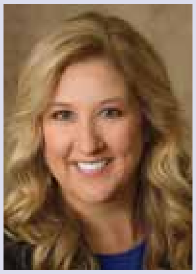
by Mandy M. Rohde, CPA



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ICCFA Magazine author spotlight

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➤The Foresight Companies LLC is a Phoenix-based business and management consulting firm specializing in mergers and acquisitions, valuations, accounting, financing and customer surveys.

We're already more than a month into 2017, so it's too late to do any tax planning before filing 2016 returns, right? Not so. Now is the time to sit down with your accountant and consider depreciation and your 2016 tax bill.

Depreciation & your 2016 tax bill: What to consider before filing

New Year's Day has come and gone. We are rolling along in 2017 and coming upon tax season. Most businesses work to complete tax planning before year-end, when you can make decisions about bonuses and expenditures that need to take place before December 31. For most business owners, tax planning ends there, but there are still decisions to be made now that can have a huge effect on your tax bill.

Depreciation is a vague, nebulous concept to many. You know that it shows up as an expense on the profit and loss statement and that it will increase gains on property when it is sold. The calculations are left to the CPA and you don't pay much attention to it, but depreciation can be a very powerful tool for small business owners.

There are several elements to consider when it comes to depreciation expenses, and if you made capital purchases during 2016, you still have time to make sure those investments provide you with the most benefit possible.

What can we depreciate?

When you purchase property for your business that is expected to be used for more than one year, it is called a capital purchase. You are investing the business assets in capital that will produce revenue for some period of time. While the capital assets produce income on a long-term basis, you will eventually need to replace them.

Depreciation methods

While there are several different methods available for calculating depreciation, the details of each method are not relevant to this discussion. There are two main ways to compute depreciation: straight-line and accelerated.

Straight-line

Straight-line depreciation is fairly self-explanatory in that it is calculated based on the same amount of depreciation each period for the life of the asset. For example, you have a $5,000 piece of equipment that will be depreciated over five years. The depreciation on that asset is $1,000 for each of the five years. The straight-line method is very popular because it is simple and easy to understand.

Accelerated

Accelerated depreciation means an asset has more depreciation in the early years of the asset life. For example, if you have an asset that will be depreciated over five years, you can depreciate it using an accelerated method that results in much larger depreciation amounts in years one and two than in years three through five.

Because the life of an asset is determined by the tax code, it can often be different from the actual useful life of the asset. For example, to keep up with technology, you may need to replace your business computers every three years, but the tax code requires you to depreciate computers over a period of five years. Using an accelerated depreciation method will allow you to recover most of the cost of the computer in the first three years when you are actually using it.

While the methods are generally prescribed, if you begin depreciating an asset using one method, you generally cannot switch methods after the first year. Be sure to review your options carefully before deciding on the method to use.

Asset life

The tax code recognizes that capital assets will not retain their value in perpetuity. The value of assets is reduced over time until they are either sold or discarded. Just as there are many types of property, there are several different time periods to use for depreciation.

Unfortunately, business owners are not able to decide the life expectancy of capital assets on their own. It's easy to see that this would result in abuse. The tax code outlines different classes of assets and the length of time each class of asset can be expected to produce income for the business. The "class life" can range from three to 39 years, depending on the type of asset. The most common assets are depreciated over five or seven years.

Most businesses reside in nonresidential real property. While most improvements to property would be classified as having the same class life, there are certain exceptions.

For example, if you make improvements to a building (leased or owned), they would generally be considered in the same class life as the building, 39 years. However, some qualified improvements can be depreciated over 15 years instead of 39. For example, certain improvements to the grounds, such as sidewalks, driveways, curbs and parking lots qualify. In addition, certain landscaping qualifies for a 15-year life.

While the list may seem very detailed, the difference in depreciating an item over 15 years rather than 39 can mean significant tax savings for you.

How is this a tool?

At this point, you are asking yourself how depreciation is a tool for business owners when the tax code prescribes both the useful life of the asset and the method of calculating the annual depreciation.

Chances are that when you purchased a new vehicle or made improvements to your facility last year, it was not with depreciation in mind, but there are a few ways to make those investments pay off for you right away.

Section 179

One of the most important sections of the tax code for small businesses is Section 179, which allows capital assets to be fully expensed in the year purchased rather than being depreciated them over their useful life.

The Section 179 election has limits and conditions, but they are generous for small businesses. For businesses that have invested no more than $2,010,000 in capital assets in 2016, up to $500,000 may be fully expensed in 2016.

There are certain limitations on some assets, such as vehicles ($25,000 each) and qualified real property ($250,000), but the remainder of the cost of the assets is then depreciated over their prescribed life.

The assets that qualify for Section 179 are tangible personal property, qualified real property and off-the-shelf computer software.

Bonus depreciation

In addition to Section 179, for the last several years, certain assets have qualified for bonus depreciation. Who doesn't love a bonus? Many of the bonus depreciation provisions were temporary but have since been made permanent.

Generally, new assets that have a life of 20 years or less are eligible for 50 percent bonus depreciation in the first year of use. As with Section 179, the remainder of the cost is depreciated over the prescribed useful life.

Can I have both?

Since both Section 179 and the bonus depreciation are incentives, the general understanding would be that you can use one or the other, but not both. However, this is one of the rare exceptions to what you might expect! For assets that qualify, both Section 179 and bonus depreciation may be used.

While you can have your cake and eat it, too, you need to remember that these are only available in the year the asset is purchased and placed in service. Section 179 does not carry over unused amounts.

Qualified improvements

In 2016, a change was made to expand the bonus available for qualified leasehold improvements to qualified improvement property. While qualified improvement property excludes elevators, certain internal structural improvements and enlargement of a building, there are several items that are included. For example, improvements to structural components of a building that benefit a common area.

Qualified improvement property also qualifies for Section 179 deductions. However, there is a special limit of $250,000 imposed on the expense for this type of property. But once again, you could have a significant amount of Section 179 expense, in addition to the 50 percent bonus depreciation and a shorter asset life.

Asset or maintenance?

Another consideration is the treatment of an expenditure as an asset that should be depreciated or as routine maintenance. It is important to know the difference between improvements and maintenance.

If the expense is recurring and expected to be performed to keep a unit of property in ordinary, efficient operating order and is expected to be performed more than once during the depreciable life (or more than once in 10 years for real property), it is routine maintenance.

Routine maintenance is a regular business expense and fully deductible. There are special guidelines regarding repair and replacement of a roof that are worth reviewing if maintenance has been performed.

Cost segregation

Another consideration when making improvements to property is segregating the cost of personal property from structural improvements. If an item is not permanently attached to the structure, it may qualify as personal property and have a shorter asset life rather than being part of the whole improvement that will be depreciated over a much longer period.

While this is not always on the radar when the improvement is being done, it could be worth the time to go back through your receipts and determine which items can be depreciated separately over the shorter period.

The bottom line is, if you made capital purchases in 2016, make sure to review them carefully with your CPA to get the full benefit available to you. Even though we are past the end of the year, you can still work to reduce your tax bill. ❐