

Using Depreciation to Your Advantage

by Quenda Behler Story

Now that last year's tax returns have been filed and all of your taxes have been paid (unless you're waiting until the last minute), you have once again vowed to do all you can to minimize your tax bill next year. One way to do this is to plan your major purchases of tools and equipment to take full advantage of the current tax laws.

This kind of planning requires talking about depreciation, something that usually sends me screaming from the room, but bear with me for a moment. In the complicated maze of tax regulation, there are some tax situations where you deduct tools, equipment, and/or materials over time by *depreciating* them. There are other situations where you deduct those tools, equipment, and/or materials by *expensing* them in the year you bought them.

Depreciating an item means that you deduct part of the cost of that item each year until you've finally written off the entire cost. Expensing an item means you can deduct the entire cost of the item from your taxable income in the year you purchased it. Remember that the specifics of your unique business are best discussed with your tax accountant.

The Logic Behind It

You don't have to worry about depreciating or expensing items that are all used up in a particular taxable year, because you don't have a choice there. Those things are expenses, and that's how you have to deduct them. Expense items include things like the cedar shakes you purchased for the roof at the Jones job, and the nails you buy to use during the year, even though you

may buy all your nails for the year at one time for the extra discount.

Tools and equipment are usually not considered expenses. They are classified as capital investments, because they have a useful life span of more than one year. The tax code generally treats capital investments as items that must be depreciated.

The purpose of depreciation is to match the cost of an item with the years you actually use it to produce income. For example, if you purchase a table saw to use on your jobs, and expect it to last for three years, you will use up one-third of its value each year. Then three years later, you will replace that saw, because you expect it to be worn out by that time.

Section 179. The letter of the law says that you expense materials and depreciate tools and equipment. However, there's a paper-pushing sort of problem here. If you buy a \$40 hammer, and you expect it to last at least ten years, you don't really want to divide that \$40 by 10 and deduct \$4 a year for ten years. Or, worse yet, you're not going to want to set up a declining-balance depreciation schedule, because that hammer's value will not decline evenly over time. It will lose most of its value in the beginning, then you'd have to fill out the appropriate IRS forms so that you can deduct \$4 — or whatever it amounts to — a year. If you're like me, you'd rather give up the deduction than go through all that paperwork.

The good news is that in Section 179, the Internal Revenue Code offers you a choice. Technically, Section 179 is an accelerated depreciation option that

allows you to recapture the cost of your tools and equipment immediately. It allows you to treat that hammer, and even that table saw, as an expense (even though it technically is not) and write off the entire cost in the year of purchase. You can do this for items that total up to \$20,000 in this tax year (2000). That amount will go up to \$24,000 in the year 2002.

Meeting the IRS requirements. The property that you choose to write off as a Section 179 expense must be property bought for your business. The computer your kids play games on doesn't qualify. Nor does any property you obtained in trade. If you hang your uncle's new bay window and he pays you with all of those power tools he bought after he retired but never used, you can't take a Section 179 deduction on those tools.

Also, you may use Section 179 only to expense an item for the tax year in which you purchased the item. If you choose to depreciate an item in one year, you can't change your mind and expense it later.

One more important exclusion — you cannot use Section 179 for any kind of land or real property, or improvements to real property. For example, if you install a furnace in your shop so that you can work comfortably in there in the winter, that furnace is legally part of the property because it is attached to the building. You can't write it off under Section 179.

The \$20,000 represents your entire Section 179 deduction limit, even if you run more than one business. Say you have an electrical subcontracting business as well as your home remodeling

business, and your spouse runs another business. The maximum amount the two of you could have taken in your joint return when filing your year 2000 tax returns is \$20,000, no matter how much equipment you bought for your different businesses.

Correct use of depreciating and expensing items enhances your cash flow. Section 179 can be a great help when you are starting out in business, because you often have lots of tools

and equipment to buy in those first years — while you're also struggling with cash-flow problems. What's especially nice about Section 179 deductions is that it doesn't matter how you paid for the items: cash, credit card, or a loan. You can deduct an item in the year you bought it regardless of how long it takes you to pay for it.

There is, of course, a special form you have to file if you want to use the Section 179 deduction — Form 4562. Don't let

that form scare you into not taking the deduction, especially when you're starting out, because wisely using Section 179 can help keep you in business through those lean early years.



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