



Special Report: Uncle Sam Wants You to Save on Taxes

Tips on making the Small Business Tax Cut work for you in 2007

Hurricane Victims Receive Additional Tax Relief

Small businesses that were damaged by Hurricane Katrina can take a bigger Section 179 deduction and have larger spending limits.

The Gulf Opportunity Zone Act of 2005, which President Bush signed in late December 2005, increases small-business deductions for property (which includes technology) purchased between Aug. 28, 2005, and Dec. 31, 2007. The law — designed to help small businesses replace lost property — provides an additional \$100,000 a year in deductions, a 50 percent bonus depreciation on property in its first year, and a spending limit that is increased by an additional \$600,000.

For 2007, for example, small businesses affected by Hurricane Katrina can deduct up to \$212,000 in equipment spending (\$112,000 standard deduction from Section 179 plus an additional \$100,000 from the Gulf Opportunity Zone Act). The spending limit increases to \$1.05 million (\$450,000 spending limit from Section 179 plus an additional \$600,000 in spending from the Gulf Opportunity Zone Act).

To take advantage of the additional deductions, however, small businesses must purchase and use the equipment in the “Gulf Opportunity Zone” areas, which include parts of Louisiana, Mississippi and Alabama.

For example, a company purchases \$1 million in new equipment that qualifies as Section 179 Gulf Opportunity Zone property. The company can expense \$212,000 immediately. With the remaining \$788,000 in expenditures, the business can deduct half of it the same year with the bonus 50 percent depreciation, which is an additional \$394,000 in deductions. With the remaining \$394,000 in spending, the company can take the regular first-year depreciation deduction. If it's a five-year property, that's a \$78,800 deduction in the first year ($\$394,000 \times 20$ percent = \$78,800). Add it all up, and the company can deduct a total of \$684,800 in the first year.

Small businesses, which have received big tax deductions for their technology purchases in recent years, can now save more than ever.

In 2007, small businesses can deduct up to \$112,000 in new equipment purchases, including IT assets such as computer hardware, networking equipment and off-the-shelf software.

Section 179 of the tax code, which allows business owners to deduct their purchases, was originally set at \$25,000 a year. But U.S. lawmakers in 2003 quadrupled the deduction to \$100,000 a year in hopes of boosting the economy. The deduction increase was initially scheduled to expire after 2005, but Congress has since renewed the deduction twice and it is now extended through 2009.

“The deduction has been very popular, which is why it's still around,” says Paul Gada, senior tax analyst for CCH Inc.'s Business Owner's Toolkit, in Riverwoods, Ill. “Legislators know there are a lot of small businesses, and it can benefit a large constituency. For small business owners, it's just a great way to invest in their business and not have to take a huge bite out of their budgets. They see an immediate impact on their tax returns every year.”

The latest version of the tax law limits the ability to deduct big sport utility vehicles and doesn't renew a temporary bonus depreciation that was put in place after the Sept. 11 attacks, but the main perk — the higher deduction — remains. That means small companies can take up to \$100,000 in deductions immediately in one tax year, rather than having the costs deducted over the course of several years under the normal depreciation schedule.

“For very small businesses, the increase of \$25,000 to \$100,000 doesn't come into play very often, but for small businesses that are expanding and need new equipment to help increase their productivity, it makes a huge difference in their taxes,” says Randy Elder, a Phoenix-based certified public accountant who specializes in small businesses.

Now is the perfect time for small business owners to strategically plan their purchases for the coming year and take advantage of the tax deduction. Accountants believe the tax deduction has given the U.S. economy a lift because many of their small business clients have taken advantage of it.

Nevertheless, accountants say some small business owners may not be aware that the larger tax deduction is still available. The media hasn't given as much attention to Section 179 since the deduction was initially increased in 2003, Gada says.

“There may be some confusion about this, but the main thing is it's still around and something that should be considered when they're making their purchasing decisions and filling out their taxes,” he says.

Basics of the Tax Incentive

Section 179 of the tax code allows businesses to deduct IT equipment, such as servers, computers, printers and off-the-shelf software, as well as other types of machinery, furniture and some storage facilities. Before Congress changed the law in 2003, off-the-shelf software did not qualify as a Section 179 deduction.

When Congress increased the tax deduction to \$100,000, it also doubled the amount businesses could spend on equipment to qualify for the tax break, from \$200,000 to \$400,000. The dollar limits are indexed for inflation. For 2006, businesses wanting to take advantage of Section 179 could deduct up to \$108,000 in equipment with a spending limit of \$430,000. For 2007, companies can deduct up to \$112,000 with a spending limit of \$450,000.

For example, if a company purchases \$200,000 in new technology in 2007, \$112,000 can be deducted under Section 179. The remaining \$88,000 can be deducted over the next several years through the normal depreciation schedule. In the first year of depreciation, the business can deduct 20 percent, or \$17,600, of the remaining \$88,000. So in total, the first-year depreciation of the new equipment is \$129,600.

Section 179 Expensing for Small Businesses

Example 2007:

Purchase **\$200,000** of new technology equipment

Deduction allowed for tax:

Section 179 expense (Indexed for inflation) = **\$112,000**

MACRS depreciation (\$200,000 - \$112,000) = \$88,000 x 20% = **\$17,600**

(HY,200%,DB)

Total first-year deduction and depreciation = **\$129,600**

There's one caveat to using Section 179 deductions. Businesses that spend above the annual spending limit are not allowed to take a full Section 179 deduction. For every dollar a business spends above the limit, the business owner must subtract a dollar from the deductions. For example, if a business spends \$470,000 in equipment purchases in 2007, or \$20,000 above the spending limit, then the business can only take a \$92,000 deduction from Section 179. The rest of the equipment costs can be deducted through the normal depreciation schedule, which is usually five to seven years.

Example 2007:

Purchase **\$470,000** of new technology equipment

Deduction allowed for tax:

Section 179 expense (Indexed for inflation less the overspending - loss of \$20,000 first-year depreciation) = **\$92,000**

MACRS depreciation (\$470,000 - \$92,000) = \$378,000 x 20% = **\$75,600**

(HY,200%,DB)

Total first-year deduction and depreciation = **\$167,600**

Elder, for example, had a client who bought more than \$500,000 worth of equipment one year, thinking he could take advantage of Section 179. But because he spent beyond the allowable limit, he could not use Section 179 and instead had to use the regular depreciation schedule.

Potential Pitfalls

To qualify for a Section 179 deduction, the business usage of an asset must be more than 50 percent, CCH's Gada says. If a company takes the Section 179 deduction and business usage falls below 50 percent or if the equipment is sold during the useful life of the asset, then the business owner must put back a portion of the deduction as income. This tax rule is called a "recapture" on the amount of deductions taken on equipment.

Take, for example, a company that buys a server for \$10,000. The business uses it 100 percent for business and expenses the entire cost the first year, but then only uses it 25 percent for business the next year. The company then will have to recapture the original deduction — minus the normal depreciation that would have been allowed — as income.

For example, under a five-year depreciation schedule, the depreciation allowed for the first year (100 percent business usage) is \$2,000. The second year of depreciation (25 percent business usage) is \$500. Combined, the allowable deduction under the normal depreciation schedule is \$2,500. That means the remaining \$7,500 that was originally deducted under Section 179 must be added back into the business owner's income.

The same is true if a business owner sells the equipment for a profit, Gada says. If you sell an item for \$6,000 and have taken \$5,000 in allowable deductions, the owner must pay additional tax from the gains made from the sale.

Deductions: Up to \$112,000 in deductions in 2007 for technology, off-the-shelf software, machinery, furniture and most storage facilities. Deductions for sport utility vehicles are now limited to \$25,000.

Spending limit: To qualify for the entire \$112,000 in deductions, capital expenditures must not exceed \$450,000 in 2007. For every dollar businesses spend above the limit, the businesses must subtract a dollar from the Section 179 deduction.

Expiration date: The higher deduction through Section 179 of the tax code will last through 2009.

For more information, visit the Internal Revenue Service Web site (www.irs.gov) and search for the IRS Publication 946, "How To Depreciate Property," or contact your tax professional.

Small Business Tax Deduction Glossary

Section 179 Expensing: Section 179 refers to the portion of the Internal Revenue Code that allows small businesses to deduct the cost of property from their income taxes.

Deduction: Amount small businesses can subtract from their income, so they can lower their taxes.

Depreciation: A deduction that allows businesses to write off the cost of computers, software and other technology over the useful lives of the assets.

Modified Accelerated Cost Recovery System (MACRS): The method used to determine asset depreciation. Under MACRS, small businesses typically write off computers and office equipment over a five- to seven-year period.

Recapture: A business that previously took a Section 179 deduction must add back a portion of the deduction as income if the business sells the equipment during its useful life or if business usage falls below 50 percent.

Source: Internal Revenue Service

Tax Deduction Strategies

Small business owners should call their tax preparer for advice because not every small business should take Section 179 deductions, Elder says.

Every situation is different. For example, if small business owners are in the 35 percent tax bracket, a \$100,000 write-off could save them \$35,000 in taxes, Elder says. On the other hand, if business owners are in a low tax bracket and aren't making much money in the current year of business but expect to make much more in the next year, then it makes sense to forgo the Section 179 deduction and use the normal depreciation schedule instead. That way, the business owners get a bigger tax benefit when they are earning more income in future years, Elder says.

In most typical cases, however, businesses should try to take the deduction all at once, Gada says. "Anything you can deduct immediately is probably better than deducting in the future. Taking the entire deduction the first year rather than depreciating over a longer period of time comes out better in terms of the time and value of money."

Another strategy is to spread purchases over two years — if you can — to maximize the \$100,000 in deductions each year, Gada says. "If you have over \$200,000 of items you want to purchase, you can split the purchases and take advantage of it one year and then the next year. You stagger it, so you can take the full deduction."

During the 2007 fourth quarter, businesses should revisit their technology spending and needs, says Danny Gass, a tax attorney and co-owner of Accounting Tax and Business Solutions, P.A., in Sunrise, Fla. If they need more equipment, they should seriously consider buying the equipment before the year ends to take advantage of Section 179, he says. Many businesses make year-end purchases for that very reason.

"If it's December, and between January and September you are planning to buy something new anyway, then buy it early to get the tax benefit," he says.

Companies, however, should not buy equipment they don't need just to use Section 179, Gass says. "You don't change good business practice just because of a tax law." ♦

