



YOUR FINANCES:

Take Advantage of a Vanishing Tax Break

January 2007, By Guy McPhail

Happy New Year! While December has passed and it's too late to alter your business investment decisions for 2006, you can still take advantage of tax breaks on 2006 business investments and make plans for doing so in 2007.

In dealing with small business owners, I am often surprised to learn that neither they nor their tax preparers are making the most of the generous provisions of the tax code that let you expense significant capital outlays immediately. A little thoughtful planning around your investment in plant and equipment now can really pay off. But delay could be painful, because the current rules are set to expire after 2009.

Specifically, we're talking about provisions of Internal Revenue Code Section 179, which became law in 2003 and were extended and made more generous in 2006. Under traditional IRS rules, businesses deduct a portion of the cost of a capital asset—anything from a drill press to a delivery truck—for depreciation. Depreciation is the amount by which the IRS allows an asset's cost to be expensed over the lifetime of that asset. The IRS issues guidelines for determining the lifespan of capital investments. Specific annual rates for each class of property are provided by IRS tables. (Follow this [link to the IRS Web site](#).)

Under Sec. 179, however, a sole proprietor, partnership or corporation can fully expense tangible property in the year it is purchased. If the cost falls below a specific limit, the entire purchase price can be deducted from the gross profits of the firm or from the personal income of the owner of an S Corporation. When Sec. 179 was enacted in 2003, the limit on expensing was \$25,000 a year; in 2006, Congress enacted Enhanced Section 179, upping the limit to \$100,000 and allowing that amount to be adjusted for inflation. This resulted in a deductible for calendar 2006 of \$108,000. (We won't know exactly what the adjusted for inflation deductible will be for 2007 until it is announced later this year.)

So, what does this opportunity look like in practice? Here are two examples.

A small business owner bought a high-capacity printer/collator/binder unit in the fourth quarter of 2006 for \$90,000 so that he could produce all of his direct-mail marketing materials in-house. Under traditional depreciation rules (MACRS, the Maximum Accelerated Recovery System rules), he would have deducted 5 percent of the cost, or \$4,500 for 2006, which is based on a useful life of five years for the machine. However, since he meets the guidelines for expensing, he can deduct the full \$90,000 from 2006 taxes. If he's the sole shareholder in an S Corporation and receives pass-through income, and if he's in the 40% tax bracket, he will realize \$34,200 in tax savings:

$$\begin{aligned} \$90,000 - \$4,500 \text{ (the depreciation he did not take)} &= \$85,500 \\ \$85,500 \times 40\% &= \$34,200. \end{aligned}$$

While he may be giving up some depreciation deductions in the future, the owner still comes out way ahead, because of the power of compounding on the resulting free cash flow. This makes the decision to expense a capital purchase a no-brainer for business owners—as long as they follow through with the critical step of investing that free cash flow in the business or in a retirement account (see previous stories in this series). A good financial planner or CPA can help you make the most of the cash flow.

Let's consider one more example. When struggling to grow her start-up business on a tight budget the company owner furnished her whole office with used furniture. Now that she has some steady cash flow, it's time to upgrade to furniture that better reflects her success and her tastes. So, she spends \$30,000 buying new office furniture. If we take the depreciation on this purchase, assuming she bought it in the third quarter of 2006, the expense would be only \$3,213. However, by electing to expense the purchase under Section 179 she can deduct the full \$30,000. As this business owner, too, is in the 40% tax bracket, her tax savings come to \$10,715.

$$\begin{aligned} \$30,000 - \$3,213 &= \$26,787 \times 40 \\ \$26,787 \times 40 &= \$10,715 \end{aligned}$$

When I help small business owners create free cash flow, as in these two examples, I always recommend they allocate their newfound tax savings to helping fund their retirement plans.

If you've made significant equipment purchases in 2006, sit down with your financial planner or CPA and see if following this tax saving strategy is right for you.

Also, remember to make yourself a note that the current IRS rules allowing for these big deductions expire at the end of 2009, at which point the deductibility limit falls back from the \$100,000 limit to just \$25,000. You'll want to keep this in mind as you do your short to mid-term financial planning for your business regarding when might be the best times for you to make significant purchases for your business and benefit from taking advantage of a high deductibility limit.

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