Alternatives to Section 179 for Year-End Tax Planning

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This is the final installment of a two-part series discussing year-end tax strategies available to reduce the tax liability of your business. **Part 1** discussed the deduction available under Code Section 179 and its applicability to a wide range of businesses. This installment discusses the de minimis safe harbor election and bonus depreciation as two other tax savings opportunities available in addition to Section 179.

THE DE MINIMIS SAFE HARBOR ELECTION

As a general rule, the Internal Revenue Code (the "Code") requires tax payers to capitalize amounts paid to purchase an asset and to depreciate that amount over the applicable depreciation schedule. For certain low cost purchases, the Code provides an exception that allows a business to expense and deduct the cost of those assets. The safe harbor applies to the purchase of a "unit of property."

Businesses may deduct the acquisition of a capital asset if three conditions are met. First, the business must have a written accounting procedure in place at the beginning of the tax year that treats property below a certain dollar amount as an expense. Second, the amount paid for the asset must be listed as an expense on the company's "Applicable Financial Statement" or its books and records. Most companies will not have an Applicable Financial Statement, as that term is defined to mean (1) a financial report filed with the SEC, (2) a financial report filed with some other state or federal agency, or (3) a certified audited financial statement. Third, the amount paid for each unit of property cannot exceed $2,500 (this amount increases to $5,000 if the company has an Applicable Financial Statement).

To illustrate how the safe harbor works, imagine a company that purchases 1,500 machines at a price of $2,500 per machine, for a total price of $3.75 million. This company may elect to use the de minimis safe harbor and deduct the entire amount. Importantly, there is no limit to the amount that may be deducted under the safe harbor, and any amounts deducted do not count against the Section 179 deduction limit. Accordingly, if the company in this example purchased a single capital asset for $500,000, it would be able to deduct the entire amount of that asset under Section 179 in addition to the deduction of $3.75 million taken under the safe harbor.

Before making the safe harbor election, it is important to determine whether your company is subject to the "UNICAP rules" found in Section 263A of the Code. If Section 263A applies to your company, the safe harbor election is not available.

BONUS DEPRECIATION

If you've maxed out your Section 179 and have purchased property not eligible for the de minimis safe harbor election, you may be able to use bonus depreciation for additional year-end tax savings. Bonus depreciation allows taxpayers to depreciate 50 percent of the cost of an asset, regardless of when that asset was placed into service. An asset qualifies for bonus depreciation if its depreciable life under the modified accelerated cost recovery system is 20 years or less and the original use of the asset commences with the taxpayer.

For example, if you purchase a $3 million asset with a depreciable life of five years and place that asset into service before the end of 2016, you may depreciate a total of $1.8 million ($1.5 million in bonus depreciation plus 20 percent of the remaining $1.5 million under the modified accelerated cost recovery system). Without bonus depreciation, you would only be able to depreciate $600,000 – 20 percent of the cost.

Aside from reducing the current year taxable income, accelerating a purchase to take advantage of bonus depreciation may be beneficial where doing so will create a net operating loss. A net operating loss may be "carried back" up to two years or carried forward for up to 20 years. On the other hand, if you have a net operating loss that is going to expire at the end of 2016, you would not want to accelerate a purchase if bonus depreciation would make you unable to use that loss.

Finally, bonus depreciation may be paired with Section 179 where the cost of the asset exceeds the Section 179 limit. For example, if a company purchases 5 year property for $1 million, Section 179 allows the company to deduct $500,000. The remaining $500,000 is subject to bonus depreciation of $250,000 and normal first year depreciation of $50,000. Accordingly, the company's total deduction for 2016 would equal $800,000. Assuming the company is taxed at the highest marginal rate of 40 percent, combining these beneficial provisions results in a tax savings of $320,000.

For more information on how your business can benefit from year-end tax strategies, contact a **Foster Swift tax attorney** today.