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Coping With the Ever Changing Depreciation Rules

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In the Beginning…..

Consider the old adage, "Two things in life are certain….death and taxes". The President has just signed into law the Economic Stimulus Act of 2008. Happily, this article is about tax law changes not death – although some may prefer death to changes in the tax laws – *in particular, changes to the depreciation rules!*

Everyone would like their tax bills reduced to compensate for their investment in business assets. Normally such purchases must be depreciated over many years. However, in 2008, the politicians really are here to help. They are passing out tax breaks for business investment and here's how it works. Along with the stimulus checks for individuals, businesses have been given two valuable incentives: the Code Section 179 expensing provision has been enhanced, and bonus depreciation has re-surfaced, benefiting virtually all businesses, whether incorporated or not. These changes require some software system support to be able to easily calculate and track applicable assets.

And Congress said 'Let there be Tax Incentives'…

This tax bill was the fourth iteration of Congress' attempt to provide business tax incentives to businesses. First, we had the Job Creation and Worker Assistance Act of 2002. This law introduced us to a new depreciation deduction called 'bonus depreciation'. Bonus depreciation is an additional first year deduction that allows businesses and individuals to deduct (write-off) an additional 30 percent of an assets cost in the year of purchase. This applied to certain assets that were purchased after September 10, 2001 and before September 11, 2004 and placed in service before January 1, 2005.

Bonus depreciation is an additional first year deduction available for businesses and individuals.

Next we had the Jobs and Growth Tax Relief Reconciliation Act of 2003. This new law gave us a 50 percent first year bonus depreciation write-off for property and changed the placed in service dates. Assets purchased and placed in service after May 5, 2003 and before January 1, 2005 would qualify for the 50 percent first year rate. In addition to this new first year rate, there was a significant increase in the Sec. 179 expensing to $100,000.00. Over and above these increases, taxpayers also had the option to elect the 30 percent bonus depreciation rate rather than the 50 percent rate for post May 5th acquisitions.

Next, the Small Business and Work Opportunity Tax Act of 2007 was signed into law on May 25, 2007 increasing the Sec. 179 first year expensing deduction to $125,000.00 retroactive to January 1, 2007. Software companies were again faced with the task of updating their software not only for the proper rates and asset classes, but ensuring that the software was now date sensitive to the placed in service date.

Finally, The Economic Stimulus Act of 2008 was signed into law on February 13, 2008 allowing bonus depreciation at the 50 percent rate. It does not allow for the election to claim the 30 percent bonus depreciation rate. The 50 percent rate must be used unless an election out of bonus depreciation is made. Let's take a closer look at how software companies incorporated these changes into their software products.

Sec. 179 expensing has been doubled to $250,000.00 and the investment threshold has been increased to $800,000.00.

And the tax professionals 'Cringed'

First, the expensing provision of Section 179 has been doubled to $250,000.00 and increases the investment threshold for the phase out to $800,000.00. This provision of the law allows a company to fully write off (expense) an asset in the year of purchase. This applies to property purchased and placed into service for taxable years beginning in 2008. Most small and medium-sized businesses will be eligible to take advantage of this change; however, due to the investment limitations imposed on the dollar amount of assets a company purchases in any given tax year, not all companies will be able to take advantage of this new enhanced law.

Second, bonus depreciation has returned for the 2008 calendar year. Bonus depreciation allows a company to write off 50% of an asset's cost as an expense in the current year, via depreciation expense, in addition to the regular depreciation expense amount that is normally allowed. Eligible property that is purchased and placed in service after December 31, 2007, and before January 1, 2009, will be entitled to claim bonus depreciation. Keep in mind that bonus depreciation must be claimed for both regular and alternative minimum tax, although taxpayers also have the option to exclude an eligible asset class from claiming bonus depreciation.

These two areas of the tax law make grown CPAs cry and software developers change professions. However, a well-established software company can manage these changes and provide complete and reliable solutions on a timely basis to their customers. These new law changes will not alter the filing of the 2007 calendar year tax returns; however, they will have an impact on the tax planning process for 2008…once the 2007 calendar year returns have been completed.

Corporate tax professionals, CPAs and those providing tax services have come to rely on their software solutions for providing specific answers to these types of questions. Even before the ink was dry on the newly signed bill, established software companies were poised to modify their software to incorporate the new rules and calculations into their solutions. Let's take a closer look at how these changes are analyzed and incorporated into the software.

Software companies solve the depreciation maze

As the details of the proposed stimulus package unfolded, it became apparent that the Code Section 179 expensing limitations would be increased and that bonus depreciation would be making a limited time come-back. The tax analyst began monitoring the bill's progress while laying out the tax logic needed by the development team to begin their design work.

Team work and specific industry knowledge are the keys to achieving the results that corporate tax professionals and CPAs not only require, but demand.

It is the responsibility of the tax department (tax subject matter experts) to provide the effective dates, rates, the desired calculated results, and communicate them to the design team. The design team then lays out the programming logic required for the software to operate in an effective manner. The programmer then writes the code based on the design specifications. It is at this important step that the tax analyst and the programmer work closely together by testing the system for accurate and efficient handling. Team work and specific industry knowledge are the keys to achieving the results that corporate tax professionals and CPA's not only require, but demand.

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To amplify the working relationships between tax and programming, consider the following two phrases: (1) “Property purchased and placed in service for tax years beginning in 2008” and (2) “Property that is purchased and placed in service after December 31, 2007 and, before January 1, 2009. To those that have never had the joy of experiencing the intricate details of tax preparation, these two phrases may seem to say the same thing….applies to my assets purchased during the 2008 year. Not so – says the tax man!

First, the key to item number one above are the words “…tax years beginning in 2008.” Generally speaking, an entity’s tax year begins on January 1st and ends twelve months later on December 31st . These dates represent the time frame within which the entity is doing business – so to speak. This is the most common type of tax year, called a “calendar year,” under which most businesses and individuals operate. An entity can also have a “fiscal year,” that is, one that starts on a date other than January 1st and ends on the last day of the twelfth month. It can have an end date or a start date shorter than twelve months due to a business termination/combination – also called a short tax year. As the new law applies to this particular situation (Code Section 179), the start date of an entity’s tax year must begin on January 1, 2008 or some other date before December 31, 2008.

Second, the key to item two above, are the words “…purchased and placed in service after December 31, 2007 and before January 1, 2009.” This represents a period of time when an asset must be purchased in order for the new tax rules to apply. It is not dependent upon an entity’s taxable year start date.

For example, let’s assume that a corporation has a fiscal year start date of October 1, 2007 and an ending date of September 30, 2008. First, since the taxable year starts in 2007, the enhanced Section179 expensing limit will not be allowed until October 1, 2008 – the start of its 2008 taxable year. Prior to that, the 2007 current year limitations of $125K/$500K must be used. Second, bonus depreciation will be allowable for eligible assets that are purchased and placed in service any time from January 1, 2008 through December 31, 2008.

Using software to answer questions like the example illustrated above is no longer a luxury. It is a necessity. As new laws are enacted, prior laws can become obsolete, be retroactive to certain dates, and be effective for prospective dates only or any combination thereof. Reliable software has the ability to remember all of the rules, whether old or new, and apply them on a consistent and reliable basis.

When choosing your software, it is important to look beyond the software and behind the scenes at the people who are providing the software, in order to have confidence that the answers are correct, accurate, and in line with the level of service you require to minimize tax compliance risk and maximize your tax savings.

About the Author

Paul R. Pavich is the Director of Tax and Accounting for Red Moon Solutions LLC. He has over 30 years of experience in the field of taxation and accounting. Paul has been working in the software development business for the paste eleven years.