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TAX IMPACT

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Plan now to maximize deductions for equipment purchases

With the April 15 income tax filing deadline on your mind, you probably aren't thinking about 2005 business tax planning. But you should be. Recent changes to the Section 179 expense election, including an increased phaseout threshold and ability to make or revoke a Section 179 election without the IRS's consent, offer greater tax-saving opportunities. By planning carefully, you can cut your company's tax bill.

Expensing 101

Ordinarily when you buy equipment and other assets for your business, you're required to depreciate the costs over several years for tax purposes. Section 179 allows you to "expense" — in other words, deduct immediately — some depreciable asset costs in the year you place items in service.

To qualify for depreciation or expensing, an asset must be "placed in service." That means the asset is ready and available for use in your business — in other words, it's operational and at the work site. But you don't necessarily have to be using the asset. Backup equipment and replacement parts, for example, are placed in service when they're available for use.

The election is available for most equipment (including "off-the-shelf" computer software), machinery, furniture and other tangible personal property purchased for use in an active trade or business. It doesn't apply to buildings or their structural components, though certain agricultural and storage structures are eligible.

How to avoid recapture

Be sure that property you expense under Section 179 is used more than 50% of the time for business. If business use drops below 50%, you'll have to recapture a portion of the Section 179 deduction and pay taxes and interest on that amount. Penalties may apply.

The recaptured amount is the excess amount you expensed minus the amount you would have deducted under regular depreciation rules.

The amount you can expense is subject to an annual limit, which is phased out on a dollar-for-dollar basis when your total investment in Section 179 property exceeds the phaseout threshold. For 2005, the expensing limit is $105,000 and the phaseout threshold is $420,000. This means that the $105,000 limit is reduced by $1 for every dollar of 2005 qualified purchases exceeding $420,000. So, for example, if you spend $460,000 on qualified property this year, the most you can expense is $65,000.

Both the expensing limit and the phaseout threshold are indexed for inflation through 2007. In 2008, the expensing limit and phaseout threshold will drop back to $25,000 and $200,000, respectively, unless Congress takes action.

Meeting the income limit

Section 179 limits expensing to a taxpayer's taxable income from all sources, so you can't use the election to generate a loss. If the taxable income limit prevents you from deducting all of your Section 179 expenses this year, you can carry over the unused deductions to future years. However, you may be better off forgoing some or all of the election this year and using ordinary depreciation deductions to generate a loss.

If you're a sole proprietor for federal tax purposes, taxable income includes any wages you earn as an employee plus your spouse's wages or self-employment income if you file a joint return. And you can carry over and deduct in future tax years expenses you're unable to deduct because of the income limit.

Let's say, for example, John invests $50,000 in equipment for a startup business. The company has no taxable income for the year, but John's wife, Mary, has $55,000 in taxable income from her job. John and Mary can deduct the entire $50,000 investment on their tax return. (The rules are more complicated for pass-through entities, such as partnerships and S corporations.)

Allocating the election

When spending more than $105,000 on qualifying property, be sure to allocate Section 179 elections where they'll do the most good, such as by selecting eligible assets with the longest recovery periods. Let's look at an example.

Suppose you buy $210,000 in qualifying property in June 2005. Half the cost is attributable to property that would normally be depreciated over five years, and the other half is seven-year property. Ordinarily, first-year depreciation would be $21,000 for the five-year property ($105,000 x 20%) and $15,005 for the seven-year property ($105,000 x 14.29%).

If you file a Section 179 election for all of the seven-year property, your first-year deduction for all your purchases would be $126,000 ($105,000 + $21,000 in depreciation on the five-year property). On the other hand, if you allocate the election to the five-year property, your first-year deduction would be $120,005 ($105,000 + $15,005 in depreciation on the seven-year property).

You may be better off forgoing some or all of the Section 179 election this year and using ordinary depreciation deductions to generate a loss.

Timing purchases

A tax rule of thumb advises that you should generally take as many deductions as possible this year and defer as much income as possible to later years. But like all rules, there are exceptions. For example, if you anticipate being in a higher income tax bracket next year, Section 179 deductions may be more valuable then, so you may want to delay planned equipment purchases until 2006.

You must also consider the half-year and midquarter conventions. For most business property you buy, the half-year convention applies. This means you must claim six months' worth of depreciation in the year you place the property in service, whether you buy it in January or December. That's why year end asset purchases are often a good tax strategy.

But if you buy too much business property late in the year, you could trigger the midquarter convention. It dictates that, if more than 40% of your depreciable asset costs for the year are attributable to assets placed in service in the last quarter, all of your asset purchases for the year must be depreciated starting in the middle of the quarter in which you placed them in service.

The midquarter convention may or may not reduce your overall depreciation allowances for the year — it depends on the timing of your asset purchases in the first three quarters. If the midquarter convention will have a negative tax effect, you can avoid it by allocating enough of your Section 179 election to last-quarter purchases to reduce the service-placement percentage to below 40%.

Getting the best result

To get the best tax result from the Section 179 election, examine your overall tax situation and select the assets that will benefit the most from expensing. Now that you can make or revoke the election on an amended tax return, it's easier to reallocate the election to correct mistakes or adjust for changed circumstances.

SUV deduction gets slashed

Business cars usually don't benefit from the Section 179 expense election because of strict depreciation limits on passenger vehicles. In 2004, for example, first-year deductions for vehicles under 6,000 pounds were capped at $2,960 (without the bonus depreciation).

And the American Jobs Creation Act of 2004 reduced the maximum first-year deduction for vehicles between 6,000 and 14,000 pounds, such as sport utility vehicles (SUVs), from $100,000 to $25,000.

Fortunately, vehicles meeting criteria such as a certain seating capacity and cargo area aren't considered SUVs for tax purposes.

Shreds of doubt

How long should you keep your tax records?

If you're like most people, tax time means digging up reams of receipts, canceled checks, bank and brokerage statements, and other records you'll need to substantiate the entries in your individual income tax return.

But once you file your return, how long do you need to hang on to those records? According to the better-safe-than-sorry school of thought, there's a simple answer: Forever.

If, however, you lack the storage space to keep years' or decades' worth of tax returns or simply have an aversion to retaining documents indefinitely, you need to know when it should be safe to use the shredder.

Mind the IRS's statute of limitations

Generally, you should keep records as long as the IRS has the ability to audit your return or assess additional taxes — in other words, until the statute of limitations expires. That means three years after you file your return or, if later, three years after the tax return's original due date.

In some cases, the statute of limitations extends beyond three years. If you understate your adjusted gross income by more than 25%, for example, the limitations period jumps to six years. And there is no statute of limitations if you fail to file a tax return or file a fraudulent one.

> There are Web-based services that will store electronic records, virtually eliminating space constraints.

Pay attention to certain records

Some types of records should be kept longer than the statute of limitations, including:

Tax returns. A wise strategy is to keep your tax returns forever. Even if you've destroyed the supporting documents, which is fine to do after the statute of limitations runs out, you never know when you'll need a copy of your individual income tax return.

For one thing, the IRS often destroys original returns after four or five years. So if the IRS comes back 10 years later and claims you never filed a return for a particular year, it can assess tax for that year even though the limitations period for properly filed returns has long since expired. As you can see, it would be very difficult to defend yourself without a copy of your tax return.

W-2 forms. You'll want to hold on to these at least until you start receiving Social Security benefits. You may need them if there's a question about your work record or earnings in a particular year.

Property records. Keep closing documents and records related to capital improvements until at least three years (preferably six years in case you understated your income by more than 25%) after you file your return for the year in which you sell the property.

Suppose, for example, you bought your home in 1985 for $300,000 and in 1995 made $200,000 in capital improvements. Ten years later, you sell the house for $1.2 million, and the IRS audits your 2005 tax return in 2009. Although the IRS is examining only your 2005 return, you'll need the records from 1985 and 1995 to document your adjusted basis in the property.

Investment records. Retain statements and trade confirmations until at least three years (preferably six years) after you file your return for the year in which you sell stocks or other securities.

Go paperless

The IRS permits you to store tax records electronically, so long as the system you use meets IRS standards. For example, the system should have:

- Reasonable controls to ensure its integrity, accuracy and reliability,
- Reasonable controls to prevent and detect tampering,
- A retrieval system that includes an indexing system,
- Inspection and quality assurance measures, and
- The capability to reproduce legible hard copies.

You can retain the documents you need by scanning the originals and storing them on CD-ROM or some other media. There are also Web-based services that will store electronic records, virtually eliminating space constraints.

Be safe, not sorry

If you have any doubt about whether to save or destroy a document, it's better to keep it — at least until you can get further guidance from your tax advisor. After all, once you destroy a document, there's no going back.

Receiving an inheritance?

Watch out for IRD issues

Once a relatively obscure concept, income in respect of decedent (IRD) can cause a surprising tax bill for some people who inherit property, especially those who receive substantial distributions from IRAs or retirement plans. By understanding IRD, you can implement strategies to minimize or eliminate the tax bite.

How IRD works

Most inherited property is free from income taxes, but IRD assets are an exception. IRD is income a person was entitled to but hadn't yet received at the time of his or her death. It includes:

- Distributions from tax-deferred retirement accounts, such as 401(k) and 403(b) plans and IRAs,
- Deferred compensation benefits and stock option plans,
- Unpaid bonuses, fees and commissions,
- Uncollected salaries, wages, and vacation and sick pay,
- Accrued but unpaid interest, dividends and rent, and
- Lottery winnings paid out over time.

IRD isn't reported on the deceased's final tax return, but it is subject to tax in his or her estate. Then it's taxed again as income to the beneficiaries who receive it.

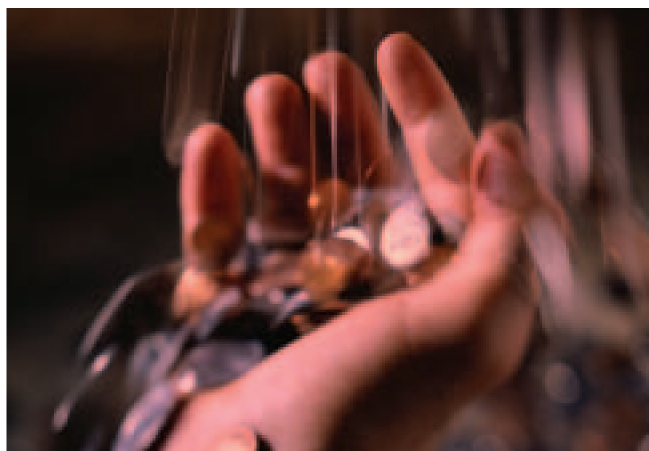
This income retains the character it would have had in the deceased's hands. So, for example, income the deceased would have reported as long-term capital gains is taxed to the beneficiary as long-term capital gains.

The deduction for heirs

The combination of estate and income taxes can quickly devour an inheritance. The tax code alleviates this double taxation by allowing beneficiaries to claim an itemized deduction for estate taxes attributable to amounts reported as IRD. (The deduction isn't subject to the 2% floor for miscellaneous itemized deductions.)

The estate tax attributable to IRD is equal to the difference between the actual estate tax paid by the estate and the estate tax that would have been payable if the IRD's net value had been excluded from the estate.

Suppose, for instance, you are the beneficiary of an estate that includes a taxable IRA. If the estate tax is $150,000 with the retirement account and $100,000 without, the estate tax attributable to the IRD income is $50,000. But be careful because any deductions in respect of decedent must also be included when calculating the estate tax impact.



When multiple IRD assets and multiple beneficiaries are involved, complex calculations are necessary to properly allocate the income and deductions. Similarly, when a beneficiary receives IRD over a period of years — IRA distributions, for example — the deduction must be prorated based on the amounts distributed each year.

If you inherit property that could be considered IRD, consult your tax advisor to ensure you're taking full advantage of deductions for estate taxes paid.

IRD estate planning strategies

If you're developing or reviewing your own estate plan, consider the potential effect of IRD on your heirs. IRD can be an unpleasant surprise for loved ones who don't expect to owe taxes on their inheritances. It can also lead to unintended results.

Suppose, for example, you want to divide your $4 million estate equally between your daughter and son, so you leave your daughter $2 million in stocks and other marketable securities and your son your $2 million 401(k) account. Assuming he'll immediately liquidate the 401(k), he'll end up with a substantially smaller inheritance than your daughter because he'll have to pay income tax on the distributions he receives from the retirement account.

You can avoid this result by distributing IRD and non-IRD assets equally among your heirs. Also, if you plan to donate some of your wealth to charity, you may be able to minimize income taxes by transferring IRD assets to a charity or charitable remainder trust and leaving non-IRD assets to your family.

Minimizing the effect of IRD

IRD can be costly, but with proper income and estate planning you can keep the cost to a minimum. There are also other techniques you can use to reduce the effect of IRD on your estate. The key is to recognize potential IRD issues and take advantage of available tax planning opportunities.

4 charitable giving options

Charitable giving can help others while reducing your tax bite. Here is a brief comparison of the tax benefits of four popular options:

1. Public charities. You can donate cash, property or other assets (such as long-term appreciated securities) directly to public charities. These gifts are generally deductible as long as your itemized deductions exceed the standard deduction and your donations don't exceed adjusted gross income (AGI) limits. Although you have no control over how your contribution is used, you bear no administrative costs.

2. Private foundations. If you want to make significant contributions, such as $1 million or more annually, or have more control over how funds are used, consider a private foundation. Because this organization is privately funded and controlled — by you — it must file income tax returns each year and pay a 1% or 2% excise tax on net investment income, depending on the type of foundation. The private foundation must bear administrative costs, but it receives a tax-advantaged status.

3. Supporting organizations. Supporting organizations are created to benefit one or more public charities. As the donor, you can create one to ally with your favorite nonprofits. The income tax deduction for these contributions is limited to a higher AGI percentage than that for contributions to private foundations. Typically, the charities you support handle the tax-filing duties and administrative costs. Note that there is no tax on investment earnings.

4. Donor-advised funds (DAFs). Many taxpayers would like the same control over charitable contributions as offered in private foundations and supporting organizations, but few have the time or funds to dedicate to these vehicles. A simpler way to achieve a similar effect is with a DAF. You can create one in your name; it is held by an organization that administers the funds and makes the grants. DAFs are more flexible than supporting organizations because they're designed to broadly benefit a variety of charities instead of just one or two. And DAFs are more economical to set up than private foundations.

However you make your contribution, and as long as you meet other requirements, you can immediately deduct contributions of long-term appreciated assets at fair market value, which allows you to avoid the capital gains tax.

Tax Tips

Are you selling your home?

If you sell your home, you may be able to exclude capital gain of up to $250,000 (or $500,000 if you're married) tax free. Among other qualifications, you must own the home at least two years and have lived in it for at least two of the five years before selling it.

But what happens if you sell the property before meeting the time requirement? You may still be able to take the exclusion, depending on why you're selling the property. If you (or your spouse) experience a change in health or employment or another "unforeseen circumstance," you may be able to exclude a percentage of the gain, which is limited to the percentage of time you met the requirements.

According to the IRS, unforeseen circumstances also include:

- Death,
- Multiple births from the same pregnancy,
- Divorce or legal separation,
- Damage to the residence because of natural or man-made disasters or acts of war or terrorism, and
- Involuntary conversion of the property such as condemnation or seizure.

The first three situations must involve you, your spouse (if you're married), a co-owner or a household member.

SMLLCs offer like-kind exchange benefits

The disregarded-entity status of single-member limited liability companies (SMLLCs) may create some interesting tax-planning opportunities. For instance, an SMLLC can receive property as part of a tax-deferred like-kind exchange, even if you owned the relinquished property. This is advantageous because SMLLCs afford liability protection, making them an excellent holding vehicle for rental properties.

Take care with IRA beneficiary designations

Improperly designating your IRA beneficiaries may trigger income and estate taxes, leaving less for your heirs. For example, if you name only a primary IRA beneficiary and he or she predeceases you, your estate will likely be the default beneficiary.

This could be disastrous tax-wise if you die before your required beginning date (RBD: April 1 following the calendar year in which you reach age 70½) to receive IRA distributions. Why? Because in that situation IRA benefits payable to an estate must be distributed within five years of your death and income tax would be immediately due. (If you die after your RBD, benefits will be payable to your estate during your remaining life expectancy.)

A contingent IRA beneficiary could enjoy more favorable tax treatment because he or she could take required minimum distributions from the inherited IRA over his or her own life expectancy. Income taxes would be payable over time, leaving more to grow tax-deferred.

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