

Section 179 - Overview - 6/1/06

Businesses benefit from Section 179 deduction.

Typically, if property for business has a useful life of more than one year, the cost must be spread across several tax years as depreciation with a portion of the cost deducted each year.

But there is a way to immediately receive these income tax benefits in one tax year. The provisions of Internal Revenue Code Section 179 allow a sole proprietor, partnership or corporation to fully expense tangible property in the year it is purchased.

And tax-law changes over the past few years have made this option much more appealing by dramatically increasing the amount that can be written off immediately. Changes first made in 2003 and then extended in 2006, mean that businesses can write off more of their capital expenditures through 2009.

Enhanced section 179 expensing now is at the base level of \$100,000 with that level indexed for inflation for the last several years. This is four times more than the previous-law limit of \$25,000. In addition, the investment limitation also has been increased to more than \$400,000 and it, too, is indexed for inflation.

These changes mean that in 2006, a business can expense \$108,000 in capital expenditures up to an overall investment limit of \$430,000.

Eligible property

Property that may be written off in the tax year of purchase, rather than depreciated over the asset's useful life, includes:

- * Machinery and equipment
- * Furniture and fixtures
- * Most storage facilities
- * Single-purpose agricultural or horticultural structures

Also, the definition of eligible section 179 property was expanded by the 2003 legislative changes to include off-the-shelf computer software. Previously, it had to be written off over three years.

The IRS says ineligible property includes:

- * Buildings and their structural components
- * Income-producing property (investment or rental property)
- * Property held by an estate or trust
- * Property acquired by gift or inheritance
- * Property used in a passive activity
- * Property purchased from related parties
- * Property used outside of the United States

How, when to use deduction

The Section 179 election is made on an item-by-item basis for eligible property. You don't have to use it on all eligible property bought in that year. The election must be made in the tax year the property is first placed in service.

The Section 179 deduction isn't automatic. Taxpayers who want to take the deduction must elect to do so. You make the election by taking your deduction on Form 4562. When you file this form, attach it to either of the following:

- * Your original tax return filed for the tax year the property was placed in service, regardless of whether you file it timely.
- * An amended return filed by the due date, including extensions, for your return for the tax year the property was placed in service.

Make sure you make the election when you file your original income tax return for that year. You can't later amend your return to elect Section 179. The only exception to this is if you amend your return before the actual due date, including extensions, of your original return.

For example, the maximum extended due date to file your return is Oct. 15. You file your return on Sept. 1 and then realize you didn't utilize the Section 179 deduction. You still have until the Oct. 15 deadline to file an amended tax return to claim the deduction.

Laws tweaked to enhance Section 179 deduction

Congress periodically reviews the amount a taxpayer can claim as the annual Section 179 amount. As part of an economic stimulus and tax-reduction package signed into law in May 2003, the expense limit was temporarily hiked from \$25,000 to \$100,000.

The Tax Tax Increase Prevention and Reconciliation Act (TIPRA), signed into law on May 17, 2006, expanded this increase through 2009.

And an inflation adjustment component means that the \$100,000 will increase while TIPRA is in effect.

Lawmakers upped and subsequently extended the section 179 deduction amount in the hopes it would encourage businesses to invest in new equipment sooner.

However, when it comes to vehicles purchased utilizing the Section 179 break, legislators took back some of the benefit as it related to large sport utility vehicles. When the limit was originally increased, business owners were allowed to select for company use one of several light-truck models (which included many luxury SUVs) weighing more than 6,000 pounds fully loaded and write off most, if not all, of the costs on their tax returns. That changed on Oct. 22, 2004, when the American Jobs Creation Act became law; now you cannot elect to expense more than \$25,000 of the cost of any heavy sport utility vehicle (SUV) and certain other vehicles placed in service during the tax year. This rule

applies to any 4-wheeled vehicle primarily designed or used to carry passengers over public streets, roads, or highways, that is rated at more than 6,000 pounds gross vehicle weight and not more than 14,000 pounds gross vehicle weight. However, the \$25,000 limit does not apply to any vehicle:

- * Designed to seat more than nine passengers behind the driver's seat,
- * Equipped with a cargo area (either open or enclosed by a cap) of at least six feet in interior length that is not readily accessible from the passenger compartment, or
- * That has an integral enclosure fully enclosing the driver compartment and load carrying device, does not have seating rearward of the driver's seat, and has no body section protruding more than 30 inches ahead of the leading edge of the windshield.

Any amount of property over the maximum deduction must be depreciated.

Limitation on annual amount of property purchased

There also is a limit on the annual total of deductible property. If the cost of qualifying Section 179 property you put into service in a single tax year now exceeds a statutory base of \$400,000 then you can't take the full deduction.

This amount also is indexed for inflation and runs through 2009.

For 2006, every dollar above \$430,000 (the inflation-adjusted limitation) that a business owner spends on eligible property, he loses a dollar in deductions.

For example, a manufacturer completely re-equips his facility this year at a cost of \$437,000. This is \$7,000 more than allowed, so he must reduce his eligible deductible limit to \$101,000: the current \$108,000 expensing limit minus \$7,000.

Deduction limited to taxable income

You have now determined the maximum deduction based on the amount of property purchased during the year. You now must pass the aggregate income hurdle.

Your deduction is limited to your aggregate taxable income from the active conduct of any trade or business. Active trade or business includes employee and spouse's wages, sole proprietorships, partnerships and S corporations. Basically, this means that unless you have other sources of business income, your Section 179 deduction can't create a taxable loss for your business.

More business owners are able to take advantage of the deduction when they combine their company earnings with those of a spouse or money earned in addition to (or before starting) their own company income.

For example, you are someone else's employee for most of the year. Your wages exceed the Section 179 deduction. You start your own business at the end of the year and purchase equipment and furniture. Even if your new business doesn't generate gross

income that year, you can still take the Section 179 deduction on the new equipment and furniture. Why? Your wages exceed the Section 179 deduction.

This aspect of inclusion also applies to a spouse. For example, you earn annual wages of \$60,000 as an employee. Your spouse doesn't work during the year but begins a new business at the end of the year. Your spouse purchases and places in service \$15,000 of Section 179 property at the end of the year. Your spouse's business doesn't generate gross income at the end of the year. Even though your spouse hasn't earned trade or business income for the year, the Section 179 deduction of \$15,000 is still allowed in full since your wages count as trade or business income.

Any amounts disallowed by the trade or business taxable income limit are carried over to the next year and added to the cost of any eligible property placed in service in that year. The same rules for maximum deduction, maximum annual investment and taxable income apply to the next tax year as well. .

Conclusion

The tax tip explains the process for using Section 179 to fully expense certain business expenses immediately instead of depreciating them across a period of several years. You should also be aware of less obvious advantages of the Section 179 deduction:

- * Lowers adjusted gross income, which could help you qualify for various deductions which are limited by AGI.
- * Lowers earned income, which can increase your earned income credit.
- * Is allowed in full even if the eligible property is placed in service on the last day of the year.

This tip also includes examples that demonstrate the three limits: the maximum dollar limit, the investment limit, and the taxable income limit. By including employment and spousal wages, many taxpayers find they are able to take advantage of this provision.

Are you interested in more information? Refer to Chapter Two of IRS Publication 946: How To Depreciate Property.

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