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3 depreciation tips you'll appreciate

A basic principle of accounting is to match income and expenses. In other words, to develop an accurate picture of your business's profitability, deduct an expense in the same year as the income it produces. That's why investments in equipment or other business assets that generate income for many years are generally depreciated gradually over their useful lives.

To encourage business investment, however, the tax code provides opportunities for companies to deduct the cost of depreciable assets more quickly or even "expense" them — that is, deduct the full cost in the year they're purchased. Here are three tips for making the most of these opportunities.

1. Take advantage of tax law

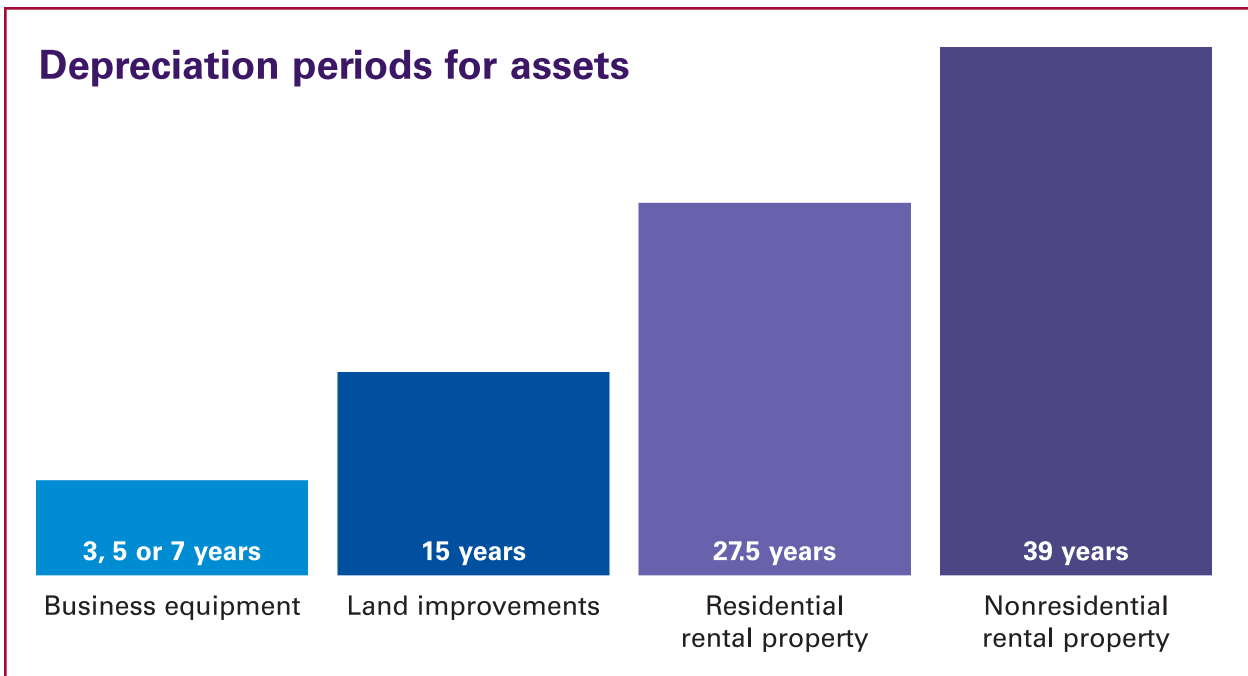
Most business equipment and other depreciable personal property are eligible for the expensing election under Internal Revenue Code Section 179. This provision allows you to deduct immediately the entire cost of up to $250,000 (up from $128,000 before the Economic Stimulus Act of 2008) in qualifying assets placed in service in calendar year 2008 or your business's fiscal year that begins in 2008.

The amount you can expense is phased out on a dollar-for-dollar basis, however, when you spend more than $800,000 in qualifying property during the year. (This amount is up from $510,000 before the Stimulus act.) This means you won't be able to expense anything under Sec. 179 if your total investments are $1,050,000 or more. Also, the election is limited to your taxable income for the year before this deduction — thus, it can't create a net operating loss.

If the amount you can expense is partially phased out, you can maximize the benefits of your Sec. 179 election by allocating it to those assets with the longest recovery periods.

2. Step on the gas

The tax code allows you to accelerate deductions for most depreciable assets, which can boost your cash flow if you've used up or are ineligible for the Sec. 179 deduction. Under ordinary straight-line depreciation, assets are depreciated over their useful lives, but the Modified Accelerated Cost Recovery System (MACRS) divides business assets into classes and specifies shorter time periods over which you can write off their costs.



Most business equipment, including office furniture and fixtures, is depreciated over three, five or seven years. The cost of residential rental property is recovered over 27.5 years, nonresidential over 39 years. Land improvements — such as fences and parking lots — are classified as 15-year property. (See the chart on page 2.) Most of these assets have useful lives that extend well beyond their MACRS recovery periods.

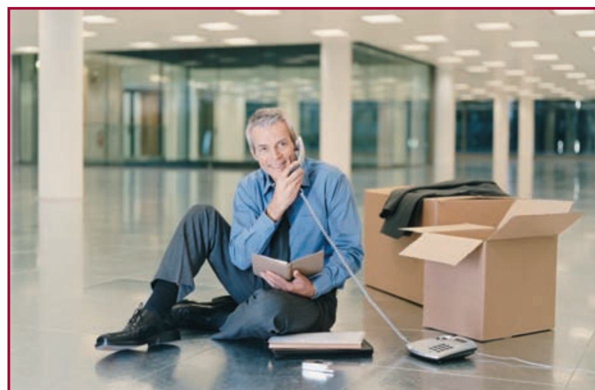
To maximize the amount of your investment that you can deduct up front, make sure costs are allocated to the appropriate asset classes. This is critical if you acquire, construct or substantially renovate a building.

Limited time offers

Along with the increased Section 179 provision in the Economic Stimulus Act of 2008 (see main article), the new law includes a 50% first-year depreciation bonus (in addition to normal depreciation) on certain assets placed in service during calendar year 2008. Qualifying assets include Modified Accelerated Cost Recovery System (MACRS) property with a recovery period of 20 years or less, water utility property, off-the-shelf computer software and certain leasehold improvements.

Also of note, through 2008, qualified Gulf Opportunity (GO) Zone property may be eligible for an expanded Sec. 179 expensing election and a special depreciation allowance. Certain types of property located in specified portions of the GO Zone enjoy a later deadline of Dec. 31, 2010. Check with your tax advisor for more information.

Often, assets that appear to be structural components of a building — such as movable partitions, certain wall and floor coverings, and light fixtures — are entitled to accelerated depreciation over much shorter periods than the building itself. A cost segregation study can identify those items, allowing you to reduce your taxes more substantially in the early years of the assets' use.



Properly classifying assets is even more important now because the Stimulus act provides a depreciation bonus for certain MACRS property placed in service this year. (See "Limited time offers" at right.)

3. Think conventionally

The timing of your business investments can have a big impact on your tax bill. Ordinarily, MACRS follows the "half-year convention," which treats assets as if they were placed in service midyear, regardless of when you actually acquire them.

The half-year convention provides a great opportunity for year end tax planning because you can generate substantial deductions by purchasing equipment late in the year. If you acquire five-year property, for example, the half-year convention allows you to deduct 20% of its cost this year, even if you place it in service on Dec. 31.

If you make more than 40% of your investment during the last quarter of the tax year, however, you'll trigger the "midquarter convention." In this case, five-year property acquired on Dec. 31 will be treated as if it had been placed in service in mid-November, reducing this year's deduction to only 5% of its cost.

On the other hand, the midquarter convention *increases* your deductions for property acquired at the *beginning* of the year. To maximize your deductions, look at your equipment needs for the year and time your purchases for the greatest tax benefit.

Learn to appreciate depreciation

It's important to also consider that in certain situations it may be better to forgo the Sec. 179 election or to defer depreciation deductions. For example, if you expect to be in a much higher tax bracket in future years, pushing more of your depreciation deductions into those years can provide a greater tax benefit.

Depreciation can have a big impact on your bottom line. Work with your CPA to see which depreciation strategies can help yours the most. ◈

Section 1244 stock offers small business investors a big advantage

Investing in a small business — especially a startup venture — can be risky. On the other hand, investing in these companies can have its rewards. Internal Revenue Code Section 1244 provides tax-advantaged treatment for investors in "qualified small business corporations." Let's take a look at how Sec. 1244 stock can work for you.

An extraordinary tool

Investors who own Sec. 1244 stock can treat losses on the sale, exchange or worthlessness of their stock as *ordinary,* rather than *capital,* losses. This is an enormous advantage, because capital losses can be deducted only against capital gains plus up to $3,000 in ordinary income in a given year. But losses on Sec. 1244 stock can be treated as ordinary losses, up to the limit of $50,000 ($100,000 for joint filers).

Here's an example that illustrates the significance. A few years ago, Bob and Cathy lent their daughter Alexis $100,000 to start a new business. Their 2008 taxable income is about $300,000, which puts them in the 33% tax bracket. They also have approximately $10,000 in long-term capital gains this year. If Alexis' business fails in 2008, Bob and Cathy's loan will be treated as a nonbusiness bad debt, deductible as a short-term capital loss. They'll be able to deduct $10,000 of that loss against their capital gains and another $3,000 against their ordinary income, for a tax savings of $2,490 [$10,000 x 15% (the current capital gains rate) + $3,000 x 33%]. The remaining $87,000 loss can be carried forward to future tax years.

Suppose that, instead of making a loan to Alexis, Bob and Cathy invested the money in Alexis' business in exchange for Sec. 1244 stock. Under this scenario, they can deduct their entire investment as an ordinary loss in 2008, generating $33,000 in federal tax savings ($100,000 x 33%). State tax savings will typically be greater as well.

How to qualify

To enjoy the tax advantages described above, you must meet several requirements:

- The business must be a C or S corporation with total invested capital of $1 million or less.
- The business must be an operating company, which means that more than 50% of its gross receipts comes from sources other than royalties, rents, dividends, interest or other investment income.
- You must receive the stock directly from the corporation rather than acquiring it from another shareholder.
- You must acquire the stock for cash or property rather than as compensation for services.

Note that, to qualify as an operating company, the corporation must meet the gross receipts test for its most recent five-year period. If it's less than five years old, it must meet the test for its entire operating history.

Nothing to lose

There's much to gain and little to lose by structuring an investment as Sec. 1244 stock. You obtain a significant tax advantage — ordinary loss treatment — in the event the business fails. If the business is a success, however, your profits are still entitled to favorable capital gains treatment. Consult your CPA if you're interested in learning whether Sec. 1244 stock is right for you. ◈

How to sow seeds of business innovation

In today's ever-changing business landscape, new opportunities are always springing up. Meanwhile, your competitors are trying to weed their way in and crowd you out of the market. Maintaining your ground requires a commitment to business innovation.

Seeds of innovation

To innovate means to continually work at applying new ideas for growing your business and developing, targeting and delivering better products and services. So, what are the seeds of innovation?

Vision. Many business owners understand the importance of short-range (one year), medium-range (three to five years) and long-range planning (10 years) to set and achieve business goals. Providing a rich and fertile base for innovation, however, means you must look considerably further into the future — 25, 50 or even 100 years out.

Consider future trends in your marketplace, including the competition, economy, technology advances and regulatory compliance. Determine how they might impact your business in terms of challenges and opportunities for growth. To keep up, it's likely you'll need to evolve your:

- Target customer base,
- Supply and distribution channels,
- Skills and technologies employed,
- Methods of operation and production,
- Types and locations of business facilities,
- Product and service offerings, and
- Financial resources.

Although planning can help you establish strong roots for growth, it shouldn't be set in stone. Rather, keep your plans flexible and review them periodically, adjusting them as needed to reflect changes in your situation and future opportunities.

Collaboration. For innovation to bloom and grow, nourish it with collaboration. Brainstorm new ideas and solutions with your managers and employees. In addition, team up with customers, suppliers, representatives of industry associations, local community members and others to identify challenges, opportunities and solutions. Finally, organize collaborative work sessions and provide online tools, such as blogs, your intranet and discussion boards, for exchanging and building on ideas.

Motivation. Including your employees in the think-tank process is likely to motivate them in their daily work, and hopefully further develop their creative thought processes and problem-solving skills. But, to increase the motivation level, consider organizing a contest to develop new ideas that will address specific business opportunities and challenges. Make sure you award the winner (or winners) in some way for their ideas. For example, give a cash prize and recognize their achievement companywide.

Watch your business grow

Growing your business through innovation requires nurturing and regular tending. By planting the seeds of innovation and establishing a formal program, you can help ensure a bountiful harvest of new business ideas. ◈

Surviving divorce: Vow to protect your financial interests

It's hard to ignore the facts: More than half of all married couples will get divorced. If you're ever among the unlucky-in-love, the last thing you need is unnecessary financial suffering on top of the emotional trauma. Let's look at some ways you can protect yourself financially before and during marriage, as well as during and after divorce proceedings.

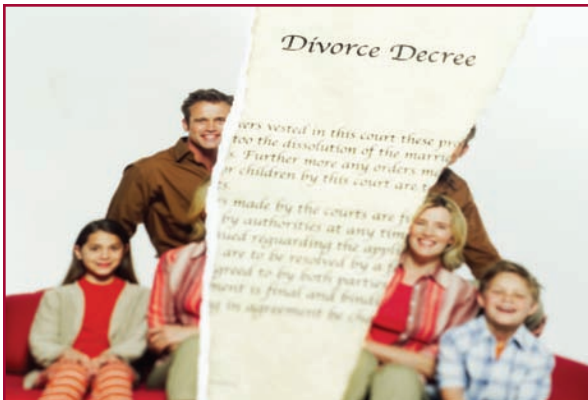
Plan *before* taking the plunge

When you vow to love, honor and cherish each other, also make a vow to protect your own financial interests. Before you say "I do," work out a prenuptial agreement to help avoid unfair division of assets should what now seems unthinkable occur. This is especially important if you're entering into marriage after having already amassed or inherited considerable wealth, or if you have children from a previous marriage whose financial interests you want to protect.

The prenuptial agreement may specify that your spouse is agreeing upfront that certain assets or amounts won't be a part of "marital assets" available to be split up upon a divorce. It's a legal document, and should be drafted by an attorney and reviewed by the attorney representing your spouse.

Be financially smart during marriage

When making any investments or asset purchases with your spouse, make sure both names are on the titles, when appropriate, and keep copies for yourself. Also continue to maintain some credit in your name alone after you marry — not jointly with your spouse — and monitor your credit reports annually to ensure you're in good standing.



Also, keep abreast of all financial-related activities and obligations throughout your marriage. It's likely that one spouse will assume primary responsibility for managing the finances, while the other is less involved. Although that makes sense for bill-paying purposes, make sure both parties stay fully informed of investments made, loans taken out and other major financial moves.

Arm yourself if divorce becomes reality

If it happens to you, make sure you copy and organize all financial-related documents. Your attorney will need them to prove who owned what and when. In particular, gather:

- Pay stubs and tax returns,
- Property deeds, appraisals and titles,
- Photos of household possessions (particularly those that you brought into the marriage),
- Utility bills,
- Regular spending and credit card records,
- Bank account, investment, retirement benefit and pension statements,
- Bond and stock certificates,
- Insurance policies, and
- Inheritance records.

It's often a good idea to close any jointly held bank and credit card accounts once a divorce is expected. This may prevent your spouse from draining bank accounts and racking up excessive bills that you could be left with.

In addition, consider carefully whether to cease contributing to any retirement accounts until an agreement is legally reached as to how they'll be divided. It's often difficult to tell in advance how different assets will be divided.

A key tool for dividing up and changing ownership of retirement and pension plan assets when legally separating and filing for a divorce is a qualified domestic relations order (QDRO). A type of legal court order, a QDRO grants ownership in the participant's plan to an alternate payee, which may include a current or former spouse, child, or other dependent. QDROs

apply only to employee benefit or pension plans subject to the Employee Retirement Income Security Act (ERISA).

Other types of legal orders are used to divide up military pay; federal civil service benefits; and state, county and municipal retirement plan benefits.

Don't overlook these essentials after splitting up

Consider whether alimony should be paid. If it qualifies as deductible to the paying spouse, it will also be taxable to the recipient. But the combined impact can often be beneficial if the paying spouse is in a higher income tax bracket. If you're the spouse receiving alimony, be sure you share in the tax benefits somehow, such as by getting an increased dollar amount.

Newly divorced individuals also often forget to update information in their estate plans. It's especially critical to revise your beneficiary designations in wills, trusts, retirement plans and life insurance policies. If you don't, upon your death, any proceeds from the settlement of your estate or insurance policies may still go to your ex-spouse.

Protect yourself now or forever hold your peace

While no one wants to enter a marriage or be in a marriage with divorce in the back of their minds, it's imperative that you protect your finances … just in case. Consult your financial, tax and legal advisors for advice specific to your personal situation. ◈

Is your tax "house" in order?

If you use household employees — such as nannies, gardeners, housekeepers, cooks or health care workers — it's important to understand your tax obligations. If you fail to pay employment taxes, you risk substantial back taxes, penalties and interest.

Are you a household employer?

You're required to fulfill certain state and federal tax obligations for any person you pay $1,600 or more (in 2008) to do work in or around your house. (The threshold is adjusted annually for inflation.)

Not everyone who works at your house is an employee, however. Workers who are properly classified as independent contractors are responsible for their own taxes. But in many cases it's difficult to distinguish between employees and independent contractors. For example, a nanny who takes care of your kids 40 hours a week is clearly an employee, while a landscaper who cleans up your yard a few times a year almost certainly isn't.

To avoid the risk of misclassifying employees as independent contractors, it's best to assume that a worker is an employee unless your tax advisor tells you otherwise.

What are your tax responsibilities?

For each household employee who earns $1,600 or more, you're required to pay the employer's half of FICA (Social Security and Medicare) taxes (7.65% of cash wages) and to withhold the employee's half. For employees who earn $1,000 or more in a calendar quarter, you must also pay federal unemployment taxes (FUTA) equal to 6.2% of the first $7,000 in cash wages. Whether or not you withhold income taxes, you're required to report employees' wages on Form W-2.

Depending on your resident state, you may be required to make state unemployment contributions, but you'll receive a FUTA credit for those contributions, up to 5.4% of wages.

When do you pay the taxes?

You can pay federal employment and withholding taxes most easily by attaching Schedule H to your Form 1040. State taxes may have to be paid separately and more frequently. Be aware that this will increase your own tax liability at filing, though the Schedule H tax isn't subject to estimated tax penalties.

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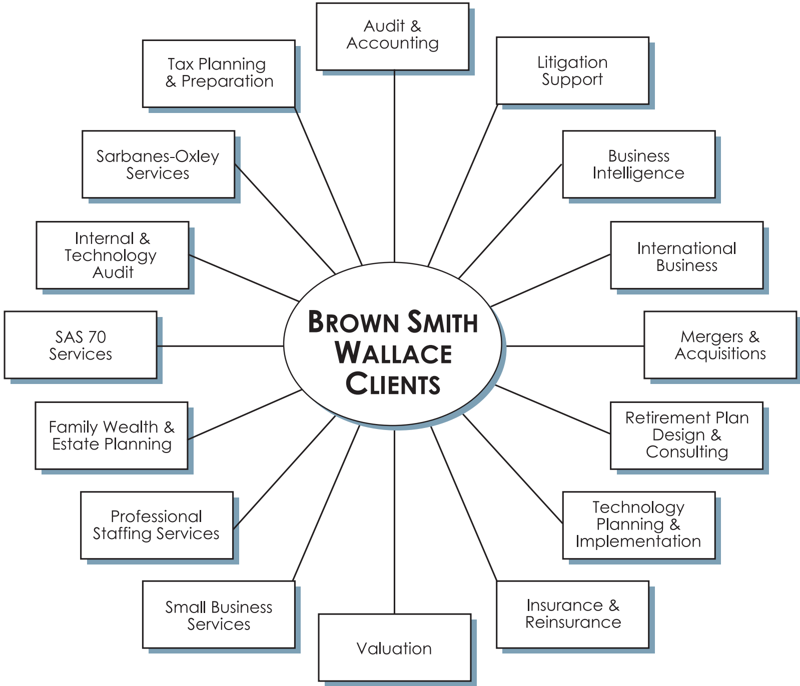

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