Finance New Mexico

Article 255 August 20, 2012

Depreciation Prevents Expense Spikes That Can Unsettle Investors

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The Internal Revenue Service stipulates that businesses must capitalize expenditures for big-ticket items and recover that cost over several years – a practice known as depreciation – to avoid dramatic changes in the financial statements of a business from one year to the next. Knowing when to depreciate and when to claim a special one-time expense deduction is critical for entrepreneurs.

Capital expenditures offer businesses an opportunity to expand operations — to modernize and grow — by buying the equipment and capital they need and deducting these costs on their income tax return. This fuels economic expansion.

Depreciation makes sense when a business makes a major capital investment that offers long-term benefits, but is purchased upfront or over the short-term. Typical candidates for depreciation include vehicles, buildings, furniture, equipment, and computer systems. Rather than frighten investors by recording the whole impact of a purchase in one financial period, where it can create a loss, a company can spread it out over many financial periods effectively matching the deduction to the period of benefit. It matters not how the loan is repaid; what matters is how long the investment is expected to provide an economic benefit. For example, if the business purchases a factory item that's likely to generate revenue for five years, the cost to purchase that item can be spread out over the estimated useful life of the item rather than showing up as a one-time cost in one financial period.

From an accounting perspective, the debt incurred for large capital expenses is normally amortized over the life of the note. Here, payments are partially interest and partially principal, with a larger amount of each payment going toward interest at the beginning of the amortization period and a greater amount dedicated toward principal near the end of that period.

Amortization protocol can get confusing when it comes to online businesses. If an online business buys its website from a contractor who has an economic stake in the website's performance, the design costs are amortized over three years, beginning the month the website is placed in service. If the company develops its website design, or hires an independent contractor to do it without assuming any risk, the company launching the website can deduct the costs in the year they're paid or amortize them under the three-year rule.

For 2012, non-customized computer software placed in service during the year is entitled to the Section 179 special expense deduction, which can be written off in full when the expense is incurred.
The Section 179 deduction is an elective provision that a company can make on its tax return. To take the deduction, one must specify the items of Section 179 qualified property to which the election applies and the portion of the asset's cost that will be taken into account.

The basis of depreciable property is generally reduced each year by the greater of the amount allowed as a depreciation deduction in computing the company's taxable income, or the amount of depreciation allowable. This "allowed or allowable" trap can result in a company losing the ability to take tax deductions for depreciation in a given year if for some unforeseen reason the company unknowingly did not claim the full amount of depreciation allowable for that year.

However, the IRS will permit the company to obtain relief from this trap by requesting an automatic change in accounting method for the under-depreciated (but not over depreciated) asset upon disposition of the asset. This is accomplished by filing Form 3115 (Application for Change in Accounting Method), which must be attached to the company's timely filed original or amended return for the year of disposal. A copy of Form 3115 must also be filed with the IRS office in Ogden, Utah no later than when the original Form 3115 is filed with the return.

Depreciation and amortization – the voluminous rules, regulations and calculations – can be daunting for business owners, but it is in the business's best interest to seek advice from a CPA for help with successfully navigating these potentially hazardous waters.

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