Season 1 – Episode 17 - Unpacking the Power of Depreciation: Strategies to Maximize Your Tax Savings

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Welcome to Tax Blueprints, a Rohr CPAs podcast. I'm Daniel Rohr, the managing shareholder of Rohr and Associates, a premier CPA firm based in California. I'm a CPA, Personal Financial Specialist and Enrolled Agent. I have extensive experience advising individuals and business owners with tax minimization and personal financial planning strategies. On each episode of Tax Blueprints, I delve into the intricacies of tax laws, explain the subtleties of business tax planning, and guide individuals towards a path of financial stability. Whether you're a business owner navigating the murky waters of taxation or an individual planning for a worry-free retirement, Tax Blueprints will provide you with the tools and knowledge you need. I hope you enjoy this episode.

Today we're discussing the topic of depreciation. Depreciation maybe sounds boring to discuss, but it can be used in a strategic way to save a lot of tax, and I will cover an in-depth example of how this works later in the podcast. I will also cover the what, why and how of it, including types of depreciation like Bonus and Section 179. So let's kick things off with a straightforward question what is depreciation? Depreciation is essentially the reduction in the value of an asset over time, particularly due to wear and tear. In the accounting world, it allows you to allocate the cost of an asset over its useful life. The IRS has provided guidelines on the useful lives of different types of assets. So let's kick off with land improvements. We're talking about landscaping, as well as parking lots and fences. So if you were to buy a commercial property and put a new parking lot, you can depreciate that cost over 15 years.

Next, we've got residential rental property. If you're a landlord with an apartment building, or maybe you rent out a second home, the IRS lets you spread out your depreciation over 27 and a half years. Now, for commercial properties, think office buildings, retail spaces or warehouses. Those have an even longer life. And it's 39 years. Depreciating those assets now to fixtures, furniture and equipment. Whether it's the new desk in your office or the heavy-duty machinery in your factory, these items usually have a useful life of between five or seven years. And what this means that you can write off their value over that period. And what if you got vehicles that you strictly use for business? You can depreciate them, too, typically over a five year period. Now, you might be wondering how these useful lives tie into the actual calculation of depreciation. That's where the Modified Accelerated Cost Recovery System, or Makers, comes in.

Makers is the default method of depreciation used for most types of business assets. Under Makers, assets are categorized into different classes, of which we just discussed. The various types which dictate the applicable recovery period or useful life. Makers allows for faster depreciation compared to the straight line method which depreciates an asset equally over its useful life. Makers often uses a method called double declining balance, which means you're writing off more of the asset's value in the earlier years of its useful life. This, of course, is beneficial, as it allows businesses to recover costs quickly. Now, depreciation is a revenue generator for the government in that it limits an expense made by a business in year one, requiring it to be deducted over years rather than just the first year. This, of course, increases a business's taxable income. Knowing this, and also to stimulate spending, congress has enacted two code provisions that allow for accelerated first year depreciation.

The first is section 168K, more commonly known as bonus depreciation and Section 179. Bonus depreciation applies automatically to all qualifying assets, which for 2023 includes assets either new or used with a useful life of less than 20 years. So land improvements and the furniture, fixtures, and equipment. For 2023, you can deduct 80% of the asset cost in the first year. This percentage will decline by 20% each year until 2026, at which point there will be no more bonus appreciation unless Congress extends it, which is highly likely given its popularity. It's important to note that after taking bonus, or 179 for that matter, you are able to write off the remaining cost of the asset over the useful life. So an 80% deduction in year one, but then you get to take whatever is left over and take it over the five years if it's a piece of equipment.

Now, regarding section 179 for 2023, the limit for qualifying equipment purchases stands at $1,160,000. This is particularly relevant for businesses contemplating significant purchases, whether that's advanced machinery, technology, infrastructure, or commercial vehicles. If your total capital expenditures for qualifying items remain under this threshold, you're eligible to fully depreciate these assets up to 1,160,000 in the current tax year. However, there is an additional layer of complexity to be aware of the phase out threshold. For 2023, this stands at $2,890,000. If your qualifying purchases exceed this amount, the abovementioned limit of 1,160,000 is reduced dollar for dollar by the excess amount. So, for instance, should your total qualifying equipment purchases for the year amount to $3 million, you would exceed the phase out threshold by 110,000. Consequently, your section 179 limit would be reduced to 1,050,000, which is 1,160,000 minus the $110,000 excess. It's also very important to understand that the 179 deduction amount is limited to your business income and is carried over to a future year if the deduction is larger than your current year income.

This means that 179 does not give you a current year loss, which can reduce your taxes from other sources of income. Bonus depreciation does not have this limit, so that is something to keep in mind when planning how to utilize these code sections. Now, in regard to planning, as I mentioned, bonus depreciation is automatic. If you want to utilize section 179, you have to elect out of using bonus depreciation and elect into 179. But as I just said, though, bonus can give you a loss and 179 can't. So why even worry about this? Here's the value of utilizing 179. It can be utilized to claim a specific amount of depreciation. Meaning if I buy a $300,000 piece of equipment, I can elect to deduct depreciation using 179 on this equipment for any amount. It could be $126,555 or $247,123. This can be a game changer when planning over multiple years to save taxes.

Let's dive into an example about this specifically. So, let's say you have a construction company owner, Jim, who is taxed as a sole proprietor. So he's not an S corporation or a C corporation or anything. It's just Jim is a sole proprietor, and he consistently makes $500,000 every year. This year, Jim buys a $625,000 excavator. This is bonus eligible as a five-year asset. So for 2023, that means Jim can deduct upfront under bonus $500,000, which is 80% of the 625. This will drop Jim's income to zero for the year. Assuming Jim's taxable income was the 500,000 and he is an unmarried taxpayer, his tax liability would be on that 500,000 with no depreciation, just the 500,000 of taxable income every year, $146,895. So Jim, utilizing bonus depreciation in full in year one, saves 146,895. But we know that Jim consistently makes 500,000 a year, and we expect him to do so in future years.

He bought a $625,000 piece of equipment, of which he has available to him a full $625,000 deduction. It just depends when he takes the deduction. Meaning he can claim bonus now or 179 now in any amount, or he can wait and deduct it over five years. We can create a strategy that will give Jim a better result. So, to go over bonus again, by utilizing bonus in full now, jim is locking in his tax savings at the 146,000 and 895. Now, I want to say I'm omitting the additional 20% that Jim can deduct in excess of bonus to make this kind of already complicated example less complicated. All right, so if we elect out of bonus and use 179, we can pick a perfect amount of depreciation to keep the current year deduction in the higher brackets. The 32% bracket for 2023 starts at $182,101.

For single filers, we can choose to deduct $317,899 of the excavator using 179 in year one, bringing Jim to the bottom of the 32% bracket. Doing this and then deducting the remaining amount over five years saves Jim $217,275 in taxes. So, to recap, by claiming bonus year one, Jim saves $146,895 in taxes. And by specifically claiming 179 to keep the deductions in higher brackets, jim saves $217,275 on the same $625,000 purchase. This demonstrates the power of proactive tax planning over a multiyear perspective. As demonstrated in this broadcast, depreciation is a powerful tax planning tool. Understanding the nuances can help you make informed decisions that benefit not just your current financial situation, but your long-term wealth building strategy.

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