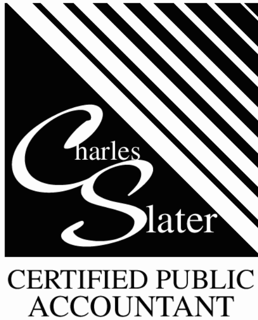

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Tax & Accounting Newsletter
A Resource for Business Owners

The purpose of this newsletter is to help business owners better understand some of the often mystifying concepts of tax and accounting. The intent here is not to turn everyone into an accountant. But, a greater understanding of these concepts should, I think, help owners to make better decisions as they manage their firms in the tough economic environment.

Your questions or comments are always welcome. If you have any comments or ideas for topics to cover, send an e-mail to Charles@SlaterCpa.com.

Business Credits and Deductions

The government continues to be a major player in efforts to restore the economy to health. In addition to direct stimulus, there have been a number of tax related measures put in place intended to stimulate greater investment in certain targeted areas of the economy. These measures normally take the form of tax credits or tax deductions. Since many people are a little hazy on the difference between a tax deduction and a tax credit, it might be a good time to briefly go over the difference between these two important concepts.

A deduction is, as the name implies, simply an amount subtracted from revenue in order to calculate taxable income. In a business tax return, ordinary and necessary business expenses are deducted from revenue in order to arrive at taxable income. The simple example below illustrates the role of deductions in the calculation of tax:

$1000	Revenue
-500	Expenses (Deductions)
$500	Taxable Income
X 10%	Tax Rate
$50	Tax Liability

An important thing to consider is the relationship of deductions to tax liability. Let us say that the amount of deductions in the above example were to increase by $100. What would be the effect on tax liability?

$1000	Revenue
-600	Expenses (Deductions)
$400	Taxable Income
X 10%	Tax Rate
$40	Tax Liability

It can be easily seen that a $100 increase in deductions resulted in a $10 decrease in tax.

A credit, on the other hand, directly acts upon the tax liability, reducing what the taxpayer must pay. Let's continue the above example by assuming that, instead of $100 increase in deductions, the taxpayer qualified for a $15 credit on his tax liability:

$1000	Revenue
-500	Expenses (Deductions)
$500	Taxable Income
X 10%	Tax Rate
$50	Tax Liability
-15	Less Tax Credit
$35	Net Tax Due

The $15 tax credit reduced his taxes by $15. Whereas a $100 tax deduction would reduce the tax due by only $10. On the face of it, a $100 deduction sounds better than a $15 tax credit. But, as we have seen, tax credits almost always have more bang for the buck.

As I stated earlier, tax credits are a very popular method to encourage business investment in certain targeted areas. Below is a listing of some of the tax credits available to businesses that have been put in place in the last few years. Many of these have received an extended life because of congressional action.

- Biodiesel and Renewable Diesel Fuels Credit – A per-gallon credit for either sale or use of a number of biodiesel related fuels.

- Electric Vehicle Credit – A credit for up to $1,000 for qualified electric vehicles placed in service. Unfortunately, golf carts seem not to qualify.

- Alternative Fuel Vehicle Refueling Property Credit – A credit for up to 30% of the cost of equipment used to store or dispense “alternative” fuels.

- Solar and Geothermal Energy Credit – Various percentage credits for the cost of placing this type of energy producing equipment in service. Extended through 2016.

- Energy efficient Home Credit for Homebuilders – A credit of either $2,000 or $1,000 for builders of homes that meet certain energy savings targets. Good through 2009.

- Credit for Increasing Research Activities - A credit for up to 20% of increased R & D activities above a base amount. Good only through 2009.

- Work Opportunity Credit – A number or credits ranging from $4,000 to $1,200 for hiring from certain targeted groups of people. Expires October, 2011.

- Differential Pay Credit – A new credit available to employers who make up the pay differential for active duty armed services members. A 20% credit for up to $20,000 in differential pay. Good through 2009.

- Disabled Access Credit - A credit for up to 50% of expenses associated with providing access to persons with disabilities. Expenses are limited to $10,250.

- Employer Tip Credit – A credit for the employer portion of FICA and Medicare taxes paid on employee tips received in excess of minimum wage. Minimum wage for this purpose is frozen at $5.15.

- Credit for Small Employer Pension Plan Startup Costs - A credit of 50% of the first $1,000 of cost incurred in establishing or administering an employer pension plan.

- Employer Provided Child Care Facilities Credit – A credit for up to 25% of the cost of qualified child care facilities.

- Rehabilitation Credit – A 10% credit for rehabilitation expenditures related to pre-1936 buildings or a 20% credit related to expenditures for certified historic structures.

If you have questions about the above tax credits or would like to see how they might apply to your business, please send me an e-mail at Charles@SlaterCpa.com.

Section 179 Deduction

Let us move from credits to an examination of deductions. For a number of years, Congress has used Section 179 of the tax code as a means of encouraging business owners to invest in productive equipment, and thus stimulate the economy. Section 179 provides a deduction, (not a credit), for the cost of certain personal property placed in service during the year, in lieu of depreciating it over its lifetime. In other words, the cost of certain property that would normally be capitalized and depreciated over a number of years can now be expensed all at once in the first year of service.

A highly simplified example will illustrate this process. Say, for example, a manufacturing company purchases a machine in 2008 for $100,000. The machine is expected to give five years of service. Normally, the cost of the machine is capitalized and allocated to expense more-or-less evenly over its five-year life. Let us assume that this results in depreciation expense from this one machine of $20,000 per year. ($100,000/5 years)

Under Section 179, the business owner now can elect not to capitalize and expense over time, but to expense the cost of the machine all in the first year of service. Instead of taking the $100,000 over five years, it all is taken in the first year. This boost in deductions considerably reduces the income tax for that first year.

	Year 1
Deduction under Sec. 179	$100000
Deduction without Sec. 179	$20000
Additional deduction provided by Sec. 179	$80000
Times Tax Rate	X 25%
Savings in Tax	$20000

Clearly this is quite an incentive for the business owner to purchase equipment. The tax savings reduces the apparent cost of the machinery. I say apparent cost because, if we look at it carefully, we can see that not much has really happened here. We have not received any greater deductions from the purchase of the machine. Under Section 179 depreciation deductions are simply shifted from the later years of an asset's life into its first year.

To illustrate this, let us consider what will happen in year two of the asset's life. Again we will compare tax savings with or without the use of Section 179:

	Year 2
Deduction after taking Sec. 179	$0
Deduction without having taken Sec. 179	$20000

Difference	$20000
Times Tax Rate	X 25%
Additional Tax in Year 2 after Sec. 179	$5000

Instead of a tax savings, there will be an additional tax burden of $5,000, all other things being equal. And the same will be true for years 3, 4, and 5. Total depreciation over the life of the asset, and the savings in taxes it provides, is exactly the same whether or not Section 179 is employed. That is why it is important to analyze the entire situation, including future tax years, before deciding to take a Sec. 179 deduction on a piece of equipment. What seems like a great deal now might not look so good down the road.

If you have any questions about the above article on the Section 179 deduction or how it related to your business, please contact me at Charles@Slatercpa.com.

Domestic Production Activities Deduction

Here is another deduction that Congress created a few years ago to stimulate the economy, particularly those businesses involved in domestic, (U.S.), activities. It is basically a percentage deduction based on income from certain activities. It is being phased in over several years and is currently, for 2009, set at 6% of "Qualified Production Activities Income." As is often the case when the IRS uses the term, "Qualified," the devil is very much in the details. But if you have a business that seems to meet the definition of Qualified Production Activities, this can be a very valuable deduction.

Despite the title emphasizing production activities, this deduction is not just limited to activities involving the production of goods. The IRS identifies five areas of qualified production activity:

- The manufacture, production, growth, or extraction in whole or significant part in the United States of tangible personal property (e.g., clothing, goods, and food), software development, or music recordings;
- Film production (with exclusions provided in the statute), provided at least 50 percent of the total compensation relating to the production of the film is compensation for specified production services performed in the United States;
- Production of electricity, natural gas, or water in the United States;
- Construction or substantial renovation of real property in the United States including residential and commercial buildings and infrastructure such as roads, power lines, water systems, and communications facilities; or
- Engineering and architectural services performed in the United States and relating to construction of real property.

One key element seems to be that all of the activities take place within the U.S. However, the regulations do allow for a "safe-harbor" in that an activity having at least 20% of its labor and overhead cost incurred domestically will still qualify. Oddly, this would mean that 80% of labor and overhead cost can be foreign sourced and still qualify as "domestic" production.

Once there is a determination that the activities of a business qualifies, at least in some part, then the deduction can be calculated. This calculation can be either quite simple or extremely complex, depending on the nature of the business. For businesses that engage in a single activity, the deduction is pretty much 6%, (in 2009), of income. For those businesses that engage in a

range of activities, some of which qualify and some of which do not, the calculation can be more complex. The key is to be able to separate the direct costs associated with the qualified activity from those costs associated with the non-qualifying activity. If the existing accounting system does not have this capability, the deduction is lost.

Some other considerations in calculating the deduction:

- Many types of activity qualify including producing products from junk or scrap.
- Agricultural activities like cultivating soil and raising livestock qualify as well as storage or processing of agricultural products.
- New construction qualifies as well as "substantial" renovation.
- Production of computer software qualifies, even video game software.
- Food and beverage prepared at a retail establishment do not qualify for the deduction.
- The deduction is limited to 50% of W-2 wages paid.
- The domestic production deduction is available for partners, members, and shareholders of pass though entities as well as individuals.
- In 2010 the deduction will go to 9% of qualified domestic production income.

This is just a basic summary of the main points of the deduction. As was said earlier, in more complex businesses the calculation of domestic production income can become very involved. The most important thing is to determine if your business potentially qualifies for the deduction and then get the accounting system organized in a way that will capture the required information. You might find that this deduction is well worth the effort.

Charles Slater, CPA is an accounting and consulting firm that seeks to offer the highest level of service to its clients. The firm has particular expertise in assisting the small business owner in managing their business. The firm also offers services in the areas of tax, payroll, accounting and bookkeeping, and financial statement compilation. For further information, please contact:

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