

## Big Changes for 2008 Depreciation plus the Zero Percent Tax Rate

The Economic Stimulus Act of 2008 may have resulted in the IRS sending you a check or electronic transfer of funds. The new law also changed some depreciation rules that can affect your tax planning and record keeping long before tax time and make a substantial difference in your income taxes for 2008. Further, the lowest tax rate for long term capital gains is 0%.

On your 2008 depreciation schedule it will be important to specify whether purchased depreciable property is new or used. It can make a large difference in the amount of 2008 additional first year depreciation that is required by the new law. First, let's check new rules for direct expensing (section 179), then consider bonus depreciation, and finally, look at the zero percent long term capital gain rate.

Direct expensing allows an expense deduction in the year of purchase for costs that normally must be deducted or depreciated over many years. The direct expensing maximum limit increased to \$250,000 for tax years that begin in 2008 (it was \$125,000 in 2007). Eligible property includes pickups over 6,000 pounds Gross Vehicle Weight Rating, farm machinery & equipment, single purpose livestock or greenhouse structures and drainage tile. For example, if a new combine cost \$300,000, then \$250,000 could be direct expensed and the other \$50,000 is left for normal depreciation. The \$250,000 limit begins phasing out at \$800,000 of eligible property purchases placed in service during the tax year. Each dollar of purchases above \$800,000 decreases the amount by one dollar. If \$1,000,000 of qualified property is placed in service, the direct expensing limit is reduced by \$200,000 (\$1,000,000 minus \$800,000) resulting in a limit of \$50,000 (\$250,000 minus \$200,000). For many farms, direct expensing may provide adequate deductions when added to normal depreciation, but for large farms or those who have deferred income in past years, additional depreciation is available for 2008.

After direct expensing deductions are taken, an additional 50% bonus depreciation is REQUIRED in 2008 for *new* property (not used) for which the Modified Accelerated Cost Recovery System (MACRS) applies and which have a class life of 20 years or less. This includes most depreciable farm property. The new combine purchased for \$300,000 in the above example could have \$50,000 of cost left to depreciate after the expense election of \$250,000. Bonus depreciation is 50% of the remaining cost of \$50,000 or \$25,000. That leaves \$25,000 left to depreciate under normal methods. Using IRS depreciation tables for 150% declining balance for 7-year property, the first year deduction for \$25,000 amounts to \$2,678. Our \$300,000 combine is allowed a first year total maximum depreciation of \$277,678 (\$250,000 direct expensing plus \$25,000 bonus plus \$2,678 regular). That leaves only \$22,322 to

depreciate in future years. There is no phase-out of bonus depreciation with an upper limit on qualifying investment property as there is with direct expensing.

Another difference between direct expensing and bonus depreciation involves trade-ins. If an old skid steer loader with a remaining basis (the amount still left on the depreciation schedule) of \$10,000 is traded-in and \$15,000 cash is paid on the new one, only direct expensing of the boot (cash) paid (\$15,000) is permitted. In contrast, bonus depreciation of \$12,500 is allowed on the total of the carryover basis of \$10,000 plus the boot of \$15,000 (50% of \$25,000). Note that the amount allowed on the trade-in by the machinery dealer has absolutely nothing to do with the amount of direct expensing or bonus depreciation.

There are unique situations with rules that differ from the general rule for 50% bonus depreciation. A new passenger auto used 100% for business is limited to an extra \$8,000 of depreciation the first year for bonus depreciation rather than 50% of the cost. That amount can be added to the \$2,960 normally allowed for 2008 first year automobile depreciation for a total limit of \$10,960.

If bonus depreciation is not desired, the IRS rules allow a taxpayer to elect out of the required 50% bonus depreciation by property class (3 year, 5 year, 7 year, 10 year, 15 year or 20 year). 50% bonus could be used for a dairy barn (10 year) and elected out for farm machinery and equipment (7 year); but all new property within the same class must be treated the same. The IRS has said that guidance on the 2004 special depreciation will be similar to this bonus depreciation. The 50% bonus depreciation allowance only applies for property purchased and placed into service after December 31, 2007 and before January 1, 2009, which means it only applies in 2008. Bonus depreciation applies for both regular income tax and the alternative minimum tax. Unlike some other states, Michigan does recognize bonus depreciation, so a separate schedule is not needed for state income tax purposes.

If a farmer is required to use the Alternate Depreciation System (ADS), bonus depreciation is not allowed. If a farmer elects to use ADS then bonus depreciation may be used. Most orchard and vineyard farmers cannot use bonus depreciation on any farm business that they operate because they elected out of the uniform capitalization rules and therefore must use ADS. This system uses the straight line method and usually has a longer class life. Direct expensing is still allowed. Listed property used 50% or less for business (an automobile might be 50% personal use) must use ADS and is not eligible for bonus depreciation, and is also not eligible for direct expensing.

A strategy to maximize depreciation in 2008 would include using direct expensing for eligible used property, using any remaining direct expense allowance expensing for new

property, and then using the 50% bonus depreciation on all the new property cost that is left. Whatever basis or cost remaining then gets normal depreciation treatment. Order makes a difference on property. The direct expensing is taken first, then 50% bonus is taken, and finally normal depreciation on the rest. The overall result is that depreciation for 2008 is tremendously flexible and allows for some unique tax planning.

Tax rates are set for the next couple of years but Congress may change them. I do not expect them to decrease. The long term capital gains rate changed from 5% and 15% in 2007 to 0% and 15% in 2008. It is scheduled to go to 10% and 20% after 2010. The lower rate is for capital gains below the 25% ordinary income bracket and the higher rate is for gains above the 15% ordinary bracket. The top of the 15% ordinary bracket is \$65,100 of taxable income for a couple married, filing jointly. If taxable ordinary income was \$55,100 plus another \$15,000 of gain from the sale of raised, cull cows, then long term gain rates would be paid of 0% federal income tax on \$10,000 of the gain ( $55,100 + 10,000 = 65,100$ ) and 15% on the amount above \$65,100 or \$5,000 of gain with the result of \$750 federal income tax on the gain. If depreciation increased by \$5,000 and taxable ordinary income was \$50,100 so all the gain (\$15,000 gain) was below \$65,100 it would save \$750 in federal tax on the capital gains (the added depreciation would also reduce ordinary federal income tax by \$750). The Michigan income tax still gets to be paid at a rate of 4.35% for 2008 for long-term gains with a 0% tax rate. (More depreciation would decrease social security taxes and decrease Michigan income tax and may increase P.A.116 or homestead credits.)

Summary:

- 1) Note whether purchased depreciable items are new or used
- 2) Direct expensing maximum limit is \$250,000 in 2008
- 3) 50% bonus depreciation is required on new purchases unless electing out of it by class
- 4) Zero percent long term capital gain rate maybe available for federal taxes on the gain

I never recommend business purchases of items just for tax purposes. But I do recommend using tax laws so that no more taxes than necessary are paid. These rules are complicated and the IRS will probably have further guidance on bonus depreciation. If you have questions, contact your dairy or farm management agent, your tax practitioner, or call me at MSU Telfarm 517-355-4700.

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