Understanding

Section 179

Tax Code

From the perspective of a CPA, few topics get a client more excited than creating a tax savings strategy or informing them of a refund. In dentistry, one of the more common tools available in tax planning is a section of the federal tax code known as "Section 179."

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Section 179 explored

The tax code allows all purchases of equipment and technology to be depreciated – an accounting method of recognizing the cost of a fixed asset over its useful life. Simply put, you match the cost of acquiring an asset with the years the asset earns revenue. For instance, the tax code indicates a dental chair should last five years, so annually a taxpayer is allowed to deduct a fifth of the cost of a dental chair on the taxpayer's tax return. This deduction for depreciation will be allowed for a period of five years, until the cost has been recognized or fully depreciated. Easy enough.

But let's add some complexity to the equation. Getting a deduction across five years, when you need tax savings in the current year, is not that exciting. Generally, when developing an effective tax strategy, a CPA seeks ways to bring deductions to the current tax year to reduce taxable income, which in turn reduces taxes owed in the current year. Essentially, an efficient tax strategy keeps cash in the hands of the client and out of the hands of the government for as long as possible. Therefore, in the concept of depreciation, taking the full deduction in the current year versus five years maximizes the immediate tax savings.

Although the tax code provides for the deduction to be over a period of years, the same tax code allows for a full deduction in the current year within code Section 179. That's more cash in your checking account and less in government coffers. Let's walk through the basic tax equation, from revenue to cash flow:

Revenue – Expenses = Taxable income

Taxable income – Income Taxes = Income

Income – Debt Service = Cash Flow

This equation calculates taxable income and determines net cash flow. For most of my clients, and probably for you, cash flow is what the equation is all about.

But for a moment, let's put on a tax strategy hat. Increasing the deduction in the current year decreases taxes. When you purchase equipment, chances are you also have a deduction that allows you to reduce income taxes.

Let's look at another example.

	Scenario 1	Scenario 2
Revenue	$908,553	$908,553
Less: Expenses	(557,289)	(557,289)
Less: Section 179 Deduction	—	(300,000)
Equals Taxable Income	351,264	51,264
Less: Income Taxes (30%)	(105,379)	(15,379)
Equals Income After Taxes	245,885	35,885
Add: Section 179 Deduction	—	300,000
Less: Debt Service	(62,496)	(62,496)
Equals Net Cash Flow	**$183,389**	**$273,389**

Scenario 1 is pretty simple and typical in nature. Scenario 2 generates $90,000 in tax savings for a simple reason: Section 179. The customer purchased $300,000 of equipment that was placed into service during the tax year. At an assumed tax rate of 30%, the taxpayer gains a deduction of $300,000, which results in additional take-home cash of $90,000.

Three golden rules

There are three rules of Section 179 you cannot forget. First, the deduction is allowed only in the year that the asset is "placed into service." This means the year in which the equipment is ready for use, not the year in which the equipment is purchased. Second, Section 179 applies to personal property, such as equipment and technology, and potentially leasehold improvements. Third, the deduction is limited to $500,000 of equipment purchases in a single year. Equipment that qualifies for the deduction but exceeds $500,000 can be depreciated across future tax years. The deduction isn't lost; it's simply delayed.

Separate from Section 179 is the concept of bonus depreciation. Like Section 179, this is also a section of the tax code that has been subject to change due to politics. Bonus depreciation is a deduction that is allowed on equipment that has not been recognized under Section 179. How much can be deducted? Fifty percent of the cost to acquire. Let's clarify with our final example.

Assume for a moment you're purchasing equipment for a remodel. Five operatories of equipment, a sterilization center, a CEREC, and a Galileos cone beam, totaling $720,000. Also assume an effective tax rate of 30%. The first $500,000 of the total cost would be subject to Section 179 deduction and would create a tax savings of $150,000 ($500,000 x 30%). The remaining $220,000 would be subject to the 50% bonus depreciation and would create a tax savings of $33,000 (($220,000 x 50%) x 30%). The total first-year tax savings on a $720,000 investment in a renovation: $183,000!

Taking the leap

So how do you decide whether this is the year to take advantage of Section 179? First, understand this principle of finance: Do not invest in an asset solely for the purpose of saving taxes. Spending money for this single purpose means that you spend a greater amount of money than the tax savings.

Second, accept this principle of finance: Invest in assets that will generate a positive rate of return. Purchasing assets such as a CEREC that can generate future income in excess of the cost to acquire the machine is a drastically different investment than "investing in a boat," which will not have a return on investment.

Last, and most importantly, ponder whether the equipment or technology you're looking at truly improves or maintains the quality of care you desire for patients. This is the best way to test your motives, and can quickly steer decisions back to a place of perspective.