Deducting Items Purchased in Dental School & Other Tax Trivia

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One of my favorite aspects of work as a Dental CPA is meeting new dentists at tax time. I enjoy speaking at dental schools before dental students and specialty residents, but it can be difficult to connect when one is preparing for boards or finishing up cases to complete a residency requirement. Visiting with a new dentist is rewarding because they have come to you for advice instead of you going to them when their attention is, appropriately, directed elsewhere.

The first tax meeting with a young dentist typically consists of lots of questions about what is deductible and what is not, how to set up an IRA, whether to be an employee or independent contractor, and whether or not to incorporate. Many times the discussion moves toward purchasing or starting a practice, or entering into a partnership or transition of some sort. These initial meetings are fun and rewarding for me and, hopefully, for the young dentist also.

During the discussion of taxes, I ask several questions. When meeting with a new dental specialist, I ask about their transition from dental school to their residency. This is because in the eyes of the IRS, someone who goes to dental school, gets licensed and begins practice as a dentist. On the other hand, someone who goes to dental school followed immediately by a specialty residency is not a dentist until the completion of that residency in the eyes of the IRS. Why is this important? If a licensed, practicing "dentist" does a specialty residency, that residency serves to improve their skills as a dentist, not train them for new profession. Thus, the costs associated with that residency are deductible business expenses. Such expenses include tuition, books, lab costs, supplies, etc. The dental student going from dental school into a residency is not able to deduct any of those costs. *See Deducting Student Loan Interest in the Progressive Orthodontist Q-2, 2012.*

Note: If you are wondering about a traditional deduction for student loan interest, the maximum amount deductible is $2,500 and the deduction is phased out once a taxpayer's Adjusted Gross Income hits $70,000.

When meeting with a new general dentist, I ask about items purchased while a dental student. All the instruments, books and other non-disposable things (assets) that are not discarded, meaning, you still have them and could refer to or use them in practice, can be depreciated (deducted) over a period of years. *This also applies to items acquired during specialty residencies.*

How does this work? Let's assume a dental student spent $40,000 on supplies, instruments, books, etc. while in dental school. Then, let's assume that individual is now a dentist working as an associate/employee and, aside from the disposable supplies, still has the items purchased in dental school. The remaining items can be classified as an asset and depreciated over 5 years. In order to do this, we must determine the amount to be depreciated. The rules state that existing personal property placed into service for business purposes must be done so at the lower of their original cost or current market value. While it is not prudent to be arbitrary when it comes to taxes, we are allowed to use estimates when other information is not available. In this case, I would suggest to my new dentist taxpayer, that we scrutinize the list of items purchased in dental school, scratch off those items that no longer exist, tally the remaining amounts and then estimate a current value for them. It might look something like this:

Total Cost of Supplies, Instruments & Books	$40,000
Less: Items disposed of	15,000
Subtotal	25,000
Estimate of Current Value	60%
Amount to be Depreciated	$15,000

The amount of depreciation on a $15,000 asset over 5 years is $3,000 per year using the "Straight Line Method". *Note that here are other formulas but they all end up with the same answer over the 5-year period.* You can do your own math based on your specific expenditures. Another option is to talk to your friendly dental supply salesperson to obtain a reasonable value. I have spoken to some dentists who attended dental schools where all the supplies, instruments and books are included in the tuition. This is a problem unless solid documentation can be obtained about the specific amounts spent on those items.

What does a $3,000 deduction do for a new dentist? It really depends. Assuming the dentist is single and earns $80,000 an employee (not an independent contractor) which is the appropriate classification in most instances, the depreciation deduction by itself does not do much since "business" deductions for employees are subject to a limitation. The limitation is that only the amount which exceeds 2% of the dentist's Adjusted Gross Income (AGI) is deductible. In this case, 2% of AGI of $80,000 is $1,600. Thus, the deduction is $1,400 ($3,000 - $1,600). All things being equal, this represents a whopping $22 tax savings.

To complicate things further, the deduction of $1,400 is classified as an "Itemized Deduction". Since not every taxpayer has Itemized Deductions, we are all given a "Standard Deduction" which, in the case of our single dentist in 2012, is $5,950. This is another hurdle to overcome but it is by no means insurmountable. There are many Itemized Deductions including taxes we pay to our state of residence, personal property taxes (often included in DMV fees) and charitable contributions (cash and non-cash). If you are a homeowner, you may also deduct your real estate taxes and home mortgage interest. In addition to unreimbursed employee business expenses, IRA and investment fees, tax preparation and safe-deposit box fees are deductible subject to the 2% limitation. Unreimbursed Employee Business Expenses include more than the depreciation of assets. In fact, most dentists have quite a few business expenses that are deductible including, Dental Association Dues, Professional Liability Insurance Premiums, Continuing Education, Meals & Entertainment, Automobile Expenses, etc. Meals & Entertainment are only 50% deductible and Automobile Expenses are only deductible for business related miles which do not include commuting. *Note that automobile expenses may be deducted under one of two methods. First, and likely the most appropriate for a new dentist is the "Standard Mileage Deduction." The standard mileage deduction for 2012 is 55.50 cents per mile. The other method is to deduct all your actual automobile expenses (gas, oil, repairs, insurance, lease payments or, in the case of a purchased auto, interest on the loan plus depreciation) times the percentage of business miles to total miles.*

Business expenses must be "ordinary and necessary" to conduct the business in order to be deductible. If we assume that our new dentist has $5,000 of deductible expenses in addition to the $3,000 of depreciation, she now has a total of $8,000 of business expenses to deduct. Since the 2% AGI limitation is still $1,600, there is $6,400 deductible ($8,000 - $1,600). Add that to state income tax of approximately $4,000 (California) and the total Itemized Deductions are $10,400 giving us a tax savings of just over $1,100.

Note that existing personal property placed into service for business purposes does not qualify for any one-time or lump-sum write-off such as "Section 179" or "Bonus Depreciation." These methods are only for assets originally purchased for use in a trade or business. Also, the term placed into service means just that: when the asset starts being used in the trade or business. So, if you bought and paid for a new X-Ray machine in late December and it is shipped to your office in January, you may not begin depreciating it (writing it off) until it is installed and operating in January. Likewise, assume you order the X-Ray machine in November and it is installed and operating in December, but you don't get the bill and pay for it until January. It doesn't matter when you pay for an asset for depreciation purposes, only when it is placed into service.

There are numerous extraordinary tax matters percolating at this time. The Bush tax cuts are set to expire and Obama-Care, which contains numerous tax provisions (increases), has been ruled constitutional by the U.S. Supreme Court. Next quarter I will summarize those, along with any yet unforeseen changes that may occur or be on the horizon, along with some strategies to minimize taxes as much as possible.

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