

LEGAL ALERT

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TAX LAW UPDATE

BUSINESS INCENTIVE PROVISIONS AND TAX PLANNING OPPORTUNITIES OF THE “JOBS AND GROWTH TAX RELIEF RECONCILIATION ACT OF 2003”

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Business Taxpayers can dramatically reduce the after-tax cost of some business property—such as equipment, machinery, furniture, cars and trucks—under new rules contained in the recently enacted Jobs and Growth Tax Relief Reconciliation Act of 2003 (the “Act”). The Act:

- Allows eligible businesses to deduct up to \$100,000 of the cost of qualifying property, provided the total cost of all such property does not exceed \$400,000. This is a temporary change to the “IRC § 179 expensing” rule, which generally limits the deduction to \$25,000, provided the total cost of all eligible property does not exceed \$200,000.
- Expands the category of property eligible for IRC § 179 expense and deduction to include off-the-shelf computer software.
- Grants a new 50% first-year “bonus” depreciation allowance similar to the 30% first-year bonus depreciation enacted in 2002. In addition, the Act extends the time period to acquire property eligible for the 30% first-year bonus depreciation allowance.
- Offers a one-time, short-term, corporate estimated tax deferral. Under this provision, any corporation that pays an estimated income tax installment due in September 2003 can defer 25% of the installment until October 1, 2003.

For your convenience, the following section of this Alert describes these temporary new rules in greater detail. This description is intended to give you additional relevant information but should not be used as a substitute for specific professional advice.

IRC § 179 Expense and Deductions

Ordinarily, a taxpayer cannot write off the cost of long-life business assets such as equipment, machinery, furniture, cars, and trucks in one tax year. Instead, the cost must be capitalized and written off over a number of years under the Tax Code’s depreciation rules. However, a special rule allows a taxpayer to elect to treat some or all of the costs of “qualifying” property as an expense rather than as a depreciable capital expenditure. This is generally known as the IRC § 179 expense deduction, named for the Tax Code section that contains this tax benefit.

The Act increases the limits of this expense deduction for property placed in service in taxable years beginning in 2003, 2004, and 2005. The maximum dollar amount that may be expensed is increased from \$25,000 to \$100,000 and the maximum amount of IRC § 179 property that may be placed in service before the tax benefit begins to be ‘phased out’ is increased from \$200,000 to \$400,000.

The Act also includes, as an asset that may be expensed, 'off-the-shelf' computer software placed in service in a taxable year beginning in 2003, 2004, and 2005. The \$100,000 and \$400,000 limitations are indexed for inflation for tax years beginning in 2004 and 2005. Under the Act, for taxable years beginning in 2003, 2004, and 2005, taxpayers may make or revoke IRC § 179 elections on amended returns without the consent of the IRS. Previously, IRC § 179 elections were irrevocable without the IRS's consent.

IRC § 168 50% First Year Bonus Depreciation Allowance

The Act also allows an additional first year depreciation deduction for both regular tax and alternative minimum tax purposes equal to 50% of the adjusted basis of qualified property for the taxable year in which the property is placed in service by the business owner.

As discussed below, this depreciation deduction applies generally to the same types of property eligible for the 30% first-year bonus depreciation as enacted last year in the Job Creation and Worker Assistance Act of 2002. Examples of such property include: equipment, machinery, furniture, cars and trucks, and 'off-the-shelf' computer software. To qualify for the 50% bonus, in addition to other requirements, the business property must be acquired after May 5, 2003, and placed in service before January 1, 2005 (or, January 1, 2006, for certain self-constructed property.) Property for which the 50% additional first-year depreciation deduction is claimed is not eligible for the 30% additional first-year depreciation deduction.

If the property also qualifies for the IRC § 179 expense deduction (discussed earlier), and the taxpayer elects to use that benefit, the 50% bonus depreciation is still available, but the property's basis is first reduced by the amount of the IRC §179 benefit before the taxpayer may apply the 50% bonus depreciation.

The tax basis of the property must be reduced by the 50% deduction before computing otherwise allowable depreciation for the first year and for later years. The depreciation deduction for the remaining basis is allowed for both regular tax and alternative minimum tax purposes.

The following examples show how the provision works.

Example (1)—No IRC § 179 deduction.

On May 6, 2003, a taxpayer buys and places in service office furniture that costs \$400,000. Without the 50% first-year bonus depreciation (and assuming the taxpayer does not use the 30% additional first-year depreciation deduction or the Section 179 expense deduction), the maximum depreciation allowance generally would be 14.29% of \$400,000, or \$57,160. In contrast, under the first-year bonus depreciation rule, the taxpayer first takes 50% of \$400,000, or \$200,000. The \$200,000 first-year bonus depreciation is then subtracted from the \$400,000 original cost basis, leaving an adjusted basis of \$200,000. The general first-year depreciation rate of 14.29% is then applied to the \$200,000, yielding a further deduction of \$28,580. The result is a total first-year depreciation deduction of \$228,580 (\$200,000 plus \$28,580), or \$171,420 more than under the general rule.

Example (2)—IRC § 179 deduction taken.

Assume the same facts as above, except that the taxpayer also uses the Section 179 expense deduction, which for 2003, as noted above, is \$100,000. By using both the first-year expensing allowance and the 50% first-year bonus depreciation, the taxpayer can deduct even more. The amount is computed as follows. First the taxpayer deducts the Section 179 benefit of \$100,000 from the original cost basis of \$400,000, leaving an adjusted basis of \$300,000, on which the 50% first-year depreciation bonus is calculated. This depreciation amount is \$150,000 (50% of \$300,000), which is subtracted from the \$300,000 adjusted basis, leaving an adjusted basis of \$150,000. The general first-year depreciation on the remaining basis of \$150,000 is 14.29%, or \$21,435. The result is a total deduction of \$271,435 (\$100,000 plus \$150,000 plus \$21,435), or \$214,275 more than under the general rule.

A taxpayer may opt out of the 50% bonus depreciation for any class of property for any taxable year, and the election will apply to all property in the same class placed in service in that year.

For passenger automobiles that qualify for the 50% first year bonus depreciation, the limitation on depreciation for the first year is increased by \$7,650. Thus, the first year depreciation deduction for any passenger automobile may not exceed \$10,710 (\$7,650 plus \$3,060 general limitation.) The latter amount is estimated based on the 2002 limit.

In order for property to qualify for the additional first-year depreciation, it must meet the following three requirements:

1. The property must be property to which the general depreciation rules apply. The modified accelerated cost recovery system (MACRS) rules, not the alternative rules apply, and it must be property with the recovery period of 20 years or less, computer software that the general MACRS depreciation rules apply, water utility property, or qualified leasehold improvement property.
2. The original use of the property must begin by the taxpayer after May 5, 2003, and before January 1, 2005. (If the property is subject to a sale/leaseback, it will be treated as originally placed in service not earlier than the date the property is used under the leaseback.) An expanded 'placed in service' date before January 1, 2006, applies to property that has a recovery period of 10 years or longer as tangible personal property used in the transportation business, but only if the property has a production period exceeding two years or an estimated production period exceeding one year, and a cost exceeding \$1,000,000. For this property, only the portion of the asset's basis attributable to the cost incurred before January 1, 2005, is eligible for the 50% additional first-year depreciation.
3. The taxpayer also must acquire the property after May 5, 2003, and before January 1, 2005, but only if no written binding contract for the acquisition was in effect before May 5, 2003, or must acquire it under a binding written contract entered into after May 5, 2003, and before January 1, 2005. For property manufactured, constructed, or produced by the

taxpayer for its own use, the taxpayer must begin manufacturer construction or production after May 5, 2003, and before January 1, 2005.

Extension of Time for 30% First Year Bonus Depreciation Allowance

As mentioned, in 2002, the Tax Code was amended to allow 30% first-year depreciation for certain property acquired after September 10, 2001, and before September 11, 2004. The 2003 Act extends its acquisition deadline to January 1, 2005. The property must be placed in service by January 1, 2005. Generally, this 30% first-year bonus depreciation is available for the same type of property that is eligible for the 50% first-year bonus depreciation described above, and except for the acquisition and placed in service date, is subject to the same rules.

Planning Opportunities From the Act for Small Business

In addition to those temporary changes to the Tax Code that impact businesses, reduction in the individual capital gains and dividend rates may provide additional planning opportunities for S corporation shareholders. S Corporations that were previously C corporations may have historical earnings and profits that subject the S corporation to the excess passive income restrictions. Because of the new lower dividend rates, it may be timely to distribute those amounts to shareholders now.

Most S corporations do not pay federal income taxes. One of the exceptions to this general rule is the "excess passive income tax." The excess passive income tax is assessed against S corporations with earnings and profits (from their previous existence as a C corporation) and report passive investment income of more than 25% of its total gross receipts. The tax is assessed against the S corporation's excess net passive income and is assessed at the highest corporate rate, currently 35%.

Another penalty that may be assessed against S corporations because of excess passive income is automatic termination of the company's S election. If an S corporation with earnings and

profits has gross receipts for three consecutive years of which more than 25% represent passive investment income, the corporation's S election is automatically terminated.

The lower dividend rates afforded by the Act present an opportunity for S corporations with earnings and profits that have significant passive investment income (or expect to in the near future) to strip out those earnings and profits by paying dividends now. By making an affirmative election to treat distributions to shareholders as coming first from earnings and profits, those

distributions are treated as dividends, and taxed at much lower tax rates. Once the earnings and profits have been reduced to zero, the S corporation is no longer exposed to the IRS's excess passive income restrictions.

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