

August 2004

Vastly Liberalized Expensing Election

The Section 179 expensing election permits small businesses to expense (i.e., to deduct immediately rather than depreciate over several years) a certain amount of the cost of tangible depreciable personal property purchased and placed in service during the tax year in an active trade or business. All of the following expensing changes are effective for tax years beginning after 2002 and before 2006:

- The maximum annual expensing amount is \$100,000 (it was previously \$25,000).
- The maximum annual expensing amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the tax year exceeds a specified dollar level. This dollar level is increased to \$400,000 (from \$200,000).
- The above increased dollar amounts will be inflation-indexed for tax years beginning after 2003.
- Off-the-shelf computer software is made eligible for expensing.

After the 2005 tax year, the limits will revert back to the previous annual expensing limit of \$25,000 with a maximum qualifying property placed in service limit of \$200,000. You will want to keep these limits in mind as you are planning your fixed asset purchases for the 2004 and 2005 tax years.

Increase and Extension of Bonus First-Year Depreciation

In general, under the recent tax acts, a 30% or 50% additional first-year depreciation allowance applies to the non-expensed portion of qualified property (which included most new MACRS property and certain qualifying leasehold improvements) if:

- (1) Its original use commenced with the taxpayer after Sept. 10, 2001; (for 50% bonus depreciation, its original use commences with the taxpayer after May 5, 2003)
- (2) The asset was acquired by the taxpayer after Sept. 10, 2001 and before Sept. 11, 2004; (for 50% bonus depreciation, the asset is acquired by the taxpayer after May 5, 2003 and before 2005; there can't be a written binding contract for acquisition in effect before May 6, 2003) and
- (3) It is placed in service by the taxpayer before 2005 (before 2006 for certain property with longer production periods)

Therefore, generally the qualifying assets must be placed in service by December 31, 2004 to be available for the additional first year bonus depreciation deduction.

- Taxpayers can elect on a class-by-class basis to claim 30% instead of 50% bonus first-year depreciation for qualifying property, or elect not to claim bonus first-year depreciation at all. Two situations in which a taxpayer would likely consider making an election to claim smaller bonus first-year depreciation (or to elect out of it entirely) are where the taxpayer (1) has about-to-expire net operating losses, or (2) anticipates being in a higher tax bracket in future years.

Note that under the 2003 Jobs and Growth Act, as under pre-2003 Jobs and Growth Act law, there is no alternative minimum tax (AMT) depreciation adjustment for the entire recovery period of qualified property recovered under the bonus first-year depreciation rules (50% or 30%).

Automobile Depreciation

Cars are subject to more restrictive rules than those that apply to other depreciable assets. Were cars not subject to the restrictive rules, you would be entitled to a deduction, for a car exclusively used in business, of 20% of the depreciable basis (cost for tax purposes) of the car in the year you place it into service. In addition, if the car were a “new” car (i.e., not a used car) acquired and placed into service before January 1, 2005, your first-year depreciation, under the “bonus depreciation” rules, would be, instead, as much as 60%. Also, it is possible that you would qualify for an election to “expense” (i.e., deduct in the first year) an even larger percentage (and, sometimes, all) of the car's basis. However, under the so-called “luxury auto” rules, depreciation and expensing deductions are artificially “capped.” For example, if, as a calendar-year taxpayer, you bought a business auto and placed it into service in 2004, your combined depreciation and expensing deduction for it, for 2004, couldn't, in even the most favorable circumstances, exceed \$10,710 (assuming that the “cap,” as annually recalculated by IRS, will be the same “cap” as applied in 2003).

Because of the restrictions for cars, you may be better off tax wise if you buy one of those popular sport utility vehicles (SUVs) instead of a car. That's because the annual depreciation and expensing caps for passenger automobiles simply don't apply to trucks or vans (and that includes SUVs) that are rated at more than 6,000 pounds gross (loaded) vehicle weight. So, for example, if you buy an over-6,000 pound SUV in 2004 for \$35,000, and use it exclusively for business, you can elect to “expense” its entire cost on the 2004 return (assuming you haven't placed more than \$410,000 worth of depreciable equipment into service during the year, and assuming that you choose to allocate \$35,000 of your allowable \$102,000 of expensing deductions to the car). Note too that if business use of the vehicle doesn't exceed 50% of total use, the SUV isn't eligible for expensing and has to be depreciated on a straight-line method over a six tax year period.

If you have any questions or would like to discuss the potential depreciation deduction on an asset purchase, please contact us.

Very truly yours,

Bruce G. Kreinbrink