

Depreciation after the 2003 Tax Act—Part 2

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LAST MONTH WE COVERED THE BASIC CHANGES

made by the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) to the rules that affect capitalization and depreciation of business assets. In particular, we focused on the general Code §179 and §168(k) changes. In this part, we will look at specific situations and offer some planning opportunities.

Small businesses should maximize their use of the \$100,000 amount that can be expensed under §179. Up to \$100,000 of §179 property may be expensed each year in 2003-2005, with that amount reverting to \$25,000 for 2006. The \$100,000 maximum is reduced dollar for dollar by the cost of §179 property that exceeds \$400,000. Any reduction is lost forever. For example, if a small business had planned purchases of \$800,000 of §179 assets for tax years 2003 and 2004, the business would want to even out annual purchases to the extent possible. Purchasing \$400,000 each year would permit \$100,000 of §179 expensing each year (\$200,000 in total). If the business purchased \$500,000 in 2003 and \$300,000 in 2004, it would obtain only a total of \$100,000 §179 expensing, all of it in 2004.

Generally, the §179 amount should be allocated to longer-lived assets because they stretch out depreciation further than shorter-lived assets. By allocating the §179 amount to longer-lived assets, more of their cost can be expensed immediately, thus accelerating a business's

depreciation deductions even quicker.

If the taxpayer chooses the assets to which it will allocate the §179 amount, the taxpayer also can affect whether the mid-quarter convention or the half-year convention will apply to assets. Although a facts and circumstances test must be employed, generally the taxpayer

would prefer use of the half-year convention. An analysis must be conducted, however, for the particular facts and circumstances. For example, application of the mid-quarter convention actually may result in a larger total first-year deduction, especially when costlier assets with shorter lives are put in service in the first quarter of a business's tax year. In determining whether more than 40% of the basis of property is put in service in the last quarter of the business's tax year, the basis *after* allocation

of the §179 expensing is the amount taken into account.

Example: A business puts \$250,000 of three-year property into service in its first quarter and \$150,000 of 10-year property into service in its last quarter. Without regard to 30% or 50% bonus depreciation, if the allowable \$100,000 §179 amount is allocated to the three-year property, the mid-quarter convention must be used to calculate regular depreciation for the assets. The total depreciation deduction from the company's purchases in the first year is \$191,245. If the \$100,000 §179 amount is allocated to the 10-year property, the half-year convention is used to calculate cost recovery for the properties, and the company's

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total first-year deduction is \$188,333.

Prior to JGTRRA, the §179 election was irrevocable. Under JGTRRA, with respect to any election made in 2003, 2004, or 2005, the election is revocable. Once the taxpayer has revoked a prior election, however, that revocation is irrevocable.

With both §179 expensing and §168(k) bonus depreciation, amounts that businesses can deduct early for a depreciable business asset represent potential recapture amounts under §1245. Thus, while taxpayers obtain larger deductions sooner for qualified property purchases, a larger amount lurks in the asset as potential §1245 recapture. If the taxpayer sells the property under an installment sales arrangement for which the taxpayer has taken substantial deductions under §179 and §168(k), the depreciation recapture must be included in the taxpayer's

taxable income in the year of sale.

Both the increased §179 deduction and the 50% bonus depreciation provision in the JGTRRA are permitted for alternative minimum tax purposes. Therefore, there will be no alternative minimum tax liability that will stem from the use of these new provisions.

Businesses should consider present and future marginal income tax rates (both federal and state) in deciding whether to elect §179 expensing or use 30% vs. 50% bonus depreciation. Generally, if future marginal rates are expected to be higher than current marginal rates, the business may want to push more depreciation deductions into the future. If the business implements this strategy, it may have to give up §179 expensing and §168(k) bonus depreciation, or it may need to use 30% bonus depreciation instead of 50%. Expected future lower marginal rates, or relatively flat marginal rates currently and in the future, generally would suggest that a business should adopt a strategy of electing §179 and using 50% bonus depreciation.

Section 168(k) permits the taxpayer to elect 30% bonus depreciation by class of property. That is, if the taxpayer elects 30% bonus depreciation for a particular class of property, then 50% bonus depreciation doesn't apply to that particular class. The taxpayer, therefore, must judiciously choose whether to use 30% or 50% bonus depreciation for each class of MACRS property.

The election as to whether to take no bonus depreciation, 30% bonus depreciation, or 50% bonus depreciation is available on an annual basis. Though the election will affect depreciation taken in future years for a class of assets placed in service in the

year of the election, it won't affect the taxpayer's choices for qualifying assets placed in service in future years.

The cost of a luxury automobile also has been revised due to the JGTRRA's increasing bonus depreciation from 30% to 50%. The new maximum allowable depreciation for an automobile in its first year of service is \$10,710 (the \$3,060 limit projected for 2003 plus the \$7,650 increase under JGTRRA). Using the formula set forth in our article on bonus depreciation ("New Depreciation Allowance Creates Benefits and Questions, Part 2," *Strategic Finance*, September 2002), the definition of a luxury automobile now is a vehicle costing \$17,850 or more [$\$10,710 = (0.50 * \text{cost of an automobile} + (0.50 * 0.20 * \text{cost of an automobile}))$]. Though the \$3,060 base amount may be adjusted in the future for inflation, the \$7,650 increase under JGTRRA is not indexed for inflation.

The increases in bonus depreciation and first-year expensing amounts allowable under JGTRRA are a significant tax break for many taxpayers, but now it's more important than ever that they carefully consider the best way to timely utilize these deductions and the related normal depreciation deductions in their businesses. Only with proper planning can taxpayers fully take advantage of these changes in the law. ■

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