

T. Dennis Connally Financial Consultants, Inc.



APRIL 2002

Business Tax Planning Under the 2002 Stimulus Act



On March 9, 2002, President Bush signed into law economic stimulus legislation (the Job Creation and Worker Assistance Act of 2002) largely aimed at encouraging businesses to invest more money in equipment and other assets by allowing them to deduct their costs more quickly. The new law also makes several other changes in the federal tax code that your business may be able to take advantage of immediately.

Depreciation Overview

Although businesses might benefit if they could simply deduct the full cost of their asset acquisitions in the year of purchase, the tax law generally doesn't allow that approach. Instead, the law says that these costs in most cases must be recovered over time through annual depreciation deductions. Deductions must be spread out regardless of

whether a business pays cash or finances the purchase.

For tangible property (property with physical existence), the amount of the annual depreciation deductions is usually determined under a series of rules called the modified accelerated cost recovery system (MACRS). To figure the deduction for a particular item, one must know not only the property's cost, but also the recovery period, depreciation method, and placed-in-service convention applicable to that type of property under MACRS. Various IRS regulations and procedures spell out the details.

Example: Company A buys a delivery truck for \$50,000 in 2002. Under MACRS, general purpose trucks belong in the five-year recovery class, and Company A may use a 200% declining balance method and a half-year convention to figure its depreciation deduction. (With the half-year convention, a half year's depreciation may be claimed in the first year, regardless of the date the asset was placed in service.) Based on these facts, Company A's first-year depreciation deduction for the truck is 20% (200% divided by 5 then divided by 2) of \$50,000 — or \$10,000.

30% Depreciation "Bonus"

The economic stimulus legislation offers businesses an opportunity to significantly increase their first-year depreciation deductions. The tax savings that result might be used to help finance the purchases themselves or meet other business objectives.

For a limited time only, the legislation provides an *additional* first-year depreciation "bonus" equal to 30% of the adjusted basis (for example: the cost) of qualified property. The bonus depreciation deduction is available for both regular tax and alternative minimum tax purposes and doesn't preclude the regular deduction for the first-year depreciation. However, the 30% deduction is subtracted from the property's adjusted basis when computing the regular deduction.

Example: Returning to our earlier example, assume Company A is able to take advantage of the additional 30% first-year depreciation deduction for the \$50,000 truck it purchases in 2002. Instead of claiming the regular 2002 depreciation deduction of \$10,000, Company A may deduct more than double that amount — \$22,000, in fact — in 2002. That amount con-

sists of \$15,000 of additional first-year depreciation (30% x \$50,000) plus \$7,000 of regular MACRS depreciation (20% x \$35,000, the truck's remaining basis after subtracting the \$15,000 of additional bonus depreciation).

A business may "elect out" of the additional 30% first-year depreciation for one or more classes of property for any tax year. The election-out might be desirable if a business expects to be in a significantly higher tax bracket in the future. Similarly, a business might want to elect out if it has a soon-to-expire net operating loss (NOL) that it is carrying forward. In this situation, the additional first-year depreciation deduction might be counterproductive if it would lower the business' taxable income to a point where the NOL expires because it couldn't be deducted.

Which Property Qualifies?

To be eligible for the additional 30% first-year depreciation, property must be subject to the general rules of MACRS (for example: the alternative depreciation system can't be used). The property must have a recovery period of 20 years or less or be eligible computer software, water utility property, or a qualified leasehold improvement to the interior of a nonresidential building.

Qualifying property generally must be placed in service before January 1, 2005, and be:

- Acquired after September 10, 2001, and before September 11, 2004 (there can't have been a binding written contract for the property's acquisition in effect before September 11, 2001), or
- Acquired pursuant to a written binding contract that was entered into after September 10, 2001, and before September 11,

2004.

Under another requirement, the 30% first-year additional depreciation deduction is available only if the original use of the property begins with the taxpayer after September 10, 2001. Thus, the property generally must be new property. However, capital expenses incurred to recondition or rebuild an asset that a business acquires or already owns also may satisfy the original use requirement.

Businesses can take advantage of the additional first-year depreciation in taxable years ending after September 10, 2001. Thus, calendar-year businesses should review their 2001 asset purchases to see if any of the assets qualify for the deduction. Non-calendar year taxpayers with 2000 tax years that ended after September 10, 2001, also should review their situations. In either case, if a return has already



been filed, the new benefit can be claimed on an amended tax return.

Residential rental property (depreciable over 27.5 years under MACRS) and nonresidential real property (depreciable over 39 years) aren't included in the categories of assets eligible for the additional 30% first-year depreciation. However, certain improvements to a leased nonresidential building

may qualify. In planning improvements to buildings that were recently placed in service, consideration should be given to the new law's requirement that there be more than three years between the dates the building and improvements are placed in service.

Interaction with Section 179

Small businesses that can take advantage of the election under Section 179 of the tax code to expense the cost of depreciable assets in the year of acquisition also may be able to utilize the additional 30% first-year depreciation available under the economic stimulus legislation. Opportunities to coordinate the two tax breaks may be available when the dollar amount of assets purchased during the year exceeds the dollar limit on Section 179 expensing — currently \$24,000 of tangible personal property (increasing to \$25,000 for 2003 and later years). Note, however, that the Section 179 election begins to phase out when purchases of otherwise eligible assets exceed \$200,000 and isn't available once the total reaches \$224,000 (\$225,000 in 2003 and later years). Still, where possible, combining the two tax breaks may produce very positive tax results, as illustrated in the following example.

Example: In 2002, Company B's asset purchases consist of \$175,000 of computer hardware and \$20,000 of office furniture. Company B makes a valid Section 179 election to expense \$24,000 of the hardware. Company B is also entitled to deduct \$45,300 of additional first-year depreciation on the hardware (30% x \$151,000 remaining ad-

justed basis) plus \$21,140 of regular depreciation based on the \$105,700 adjusted basis that remains. Thus, a total of \$ 90,440—over half of the hardware’s cost—may be written off in 2002. While not eligible for Section 179 expensing because the \$24,000 limit has already been met, Company B’s furniture purchases are eligible for both the 30% additional first-year depreciation deduction and a regular MACRS depreciation deduction in 2002.

Passenger Automobile Depreciation

The tax law caps the amount of annual depreciation a business taxpayer may claim for “passenger automobiles” (vehicles, including some trucks, that weigh 6,000 pounds or less and that are used in the business). The economic stimulus legislation increases the first-year depreciation dollar limit by \$4,600 for such vehicles acquired after September 10, 2001, and placed in service before January 1, 2005. Thus, for example, if a vehicle is placed in service during 2002 and used entirely for business, this change raises the dollar cap on first-year depreciation from \$3,060 to \$7,660. Note that, for companies that purchase vehicles for employee business use, this increase in the first-year depreciation limit can mean significant tax benefits.

Note also that a car won’t be eligible for the additional first-year depreciation unless it is used more than 50% or less in a subsequent year, the business may have to recapture (include in income) a portion of the depreciation previously claimed.

Net Operating Losses

A net operating loss (NOL) is the excess of business deductions (with certain adjustments) over business income for the year. Carrying back

an NOL to a previous tax year allows taxpayers to offset taxable income in the carry back year and obtain tax refund. The economic stimulus legislation temporarily extends the generally applicable carry back period from two to five years for NOLs arising in taxable years ending in 2001 and 2002. NOLs that aren’t carried back may be carried forward for up to 20 years to reduce future taxable income. As under prior law, a taxpayer may elect to waive the carry back period.

Example: Company C has been profitable in past years, but generated a \$100,000 NOL in 2001. At Company C’s election, the NOL may be carried back to 1996 to offset taxable income in that year. If there isn’t sufficient 1996 income to absorb the full loss, Company C may carry back the remaining loss, Company C may carry back the remaining loss to its 1997, 1998, 1999, and 2000 tax years, in that order. Under prior law, Company C could have carried back the NOL only to 1999 and 2000.

Deductions for NOLs attributable to carry backs arising in taxable years ending in 2001 and 2002 — as well as NOL carry forwards to 2001 and 2002 — may offset 100% of alternative minimum taxable income. Normally, an NOL deduction may not reduce alternative minimum taxable income by more than 90% of the income.

To obtain a tax refund from an NOL carry back, a corporation may use Form 1139, *Corporation Application for Tentative Refund*, or Form 1120X, *Amended U.S. Corporation Income Tax Return*. The corporation must file its income-tax return for the NOL year before it files Form 1139. The form is due no later than one year after the year the NOL was sustained. There is a

three-year deadline for filing ³ Form 1120X (measured from the due date of the loss year return, plus extensions). Individuals use Form 1045, *Application for Tentative Refund*, or Form 1040X, *Amended U.S. Individual Income Tax Return*, to carry back an NOL.

Note that, for some businesses, the new law’s depreciation changes may result in an NOL for 2001 (or for non-calendar year taxpayers, for 2000) that may not have been realized under prior law. Businesses need to examine their situations, and, in the case where a tax return has already been filed, an amended return and NOL claim may be warranted.

Other Provisions

The economic stimulus legislation contains several other tax provisions of interest to businesses.

New York City Tax Relief

The new law provides tax benefits for businesses located in the area of New York City damaged by the terrorist attacks (the “Liberty Zone”). Among those benefits:

- Creation of a new targeted group that includes certain workers affected by the attacks for whom businesses with up to 200 employees can claim a Work Opportunity Tax Credit. In 2002 and 2003, a credit is allowed for up to \$2,400 of wages per qualifying employee per year.
- An additional 30% first-year depreciation deduction for certain property purchased and placed in service after September 10, 2001, and before January 1, 2007 (January

- 1, 2010, in the case of nonresidential real property and residential rental property);
- Quicker depreciation for certain leasehold improvements in the affected area; and
- A \$35,000 increase in the \$24,000 (\$25,000 after 2002) Section 179 expensing election for certain otherwise depreciable assets (for property purchased and placed in service after September 10, 2001, and before January 1, 2007).

Electronic Forms

Prior to the legislation, businesses could choose to furnish Form W-2, *Wage and Tax Statement*, by electronic means to those employees who consented to that form of delivery. Beginning with tax years ending after March 9, 2002, the new law allows additional specified information returns (for example, Form 1099) to be provided to recipients electronically, as long as the recipient has consented. Planning tip: Most businesses with significantly reporting requirements should find electronic delivery to be very cost effective. If this is the case, a business should begin developing ways to take advantage of this provision for its 2002 tax year information returns.

Pension Corrections

The new law contains numerous technical corrections to prior laws. Many of the corrections relate to pension legislation included in the Economic Growth and Tax Relief Reconciliation Act of 2001. Among other items, the new legislation:

- Clarifies that the small business tax credit for new retirement plan expenses applies in the case of a plan first effective after December 31, 2001, even if the plan was adopted on or be-

fore that date.

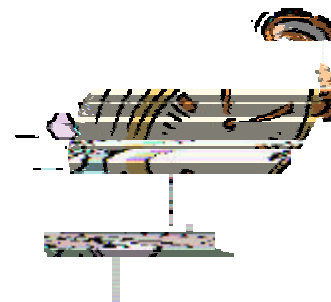
- Spells out that a plan participant who reaches age 50 by the end of the taxable year is eligible to make "catch-up" contributions to a qualifying retirement plan during that year. So, if the calendar year is the tax year, a participant turning 50 on December 31 is eligible to make catch-up contributions for that year.

Extension of Expiring Tax Credits

Prior to the new law, the Work Opportunity Tax Credit and the Welfare-to-Work Opportunity Tax Credit and the Welfare-to-Work Tax Credit (two incentives for hiring certain targeted groups of workers) applied only to wages paid to or incurred in regard to a qualified employee who began work before 2002. The new law extends both credits for wages paid to a qualified individual who begins work after 2001 and before 2004. Thus, hiring workers in the targeted groups will continue to provide tax benefits to employers.

In addition, the tax credit for using alternative energy sources (for example: wind) for the production of electricity is extended to apply to qualified facilities placed in service before 2004. Under previous law, the credit applied only to facilities placed in service before 2002. Also, effective for property placed in service after 2001, the new law makes the full 10% credit for the purchase of electric vehicles available for qualified purchases made in 2002 and 2003, and phases down the credit from 2004 through 2006. It will not be available for vehicles placed in service after 2006. Under prior law, the credit was to have been phased out from 2002 through 2004.

It will not be available for vehicles placed in service after 2006.



A Friendly Reminder:

Our office will be closed at noon on April 12, 2002 and all day on April 15, 2002

Please have all tax returns picked up on or before April 10, 2002

An extension has been filed for those that have not brought in their tax information, if you do not want one please call the office to have your name removed from the list.

Thanks to all of our clients for working with our office during the 2002 tax season!