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PRACTICAL MATTERS

Tax legislation offers small-business incentives

President Bush recently signed into law new tax legislation called the American Jobs Creation Act of 2004. The bill was originally intended to serve as a vehicle for resolving a long-standing dispute with the World Trade Organization over a feature of our nation's system for international business taxation that the WTO ruled was an illegal export subsidy.

The bill evolved as Congress continued to target abuses involving corporate tax shelters in the wake of the Enron, WorldCom and other recent corporate scandals. However, tucked away in law are several less publicized provisions that provide some important tax incentives to small businesses. Here are some of the more important ones.

•Increased expensing: One of the new incentives extends for an additional two years, through 2007, a provision that allows taxpayers to expense up to $100,000 of the cost of qualified property placed in service during the year. Previously, the expense deduction limit was limited to $25,000 for years after 2005.

Without this provision, a business taxpayer normally must capitalize — instead of currently writing off — the cost of a newly acquired asset and then is permitted to write off such cost only incrementally over a predetermined number of years through depreciation deductions.

Qualifying property is generally defined as depreciable tangible property — i.e., machinery, furniture, equipment — and for tax years through 2007 also includes "off-the-shelf" computer software. Qualifying property does not include buildings and similar improvements to real estate.

Prior to the new law, the expensing deduction was subject to a phase-out if the total cost of qualified property acquired during a particular year exceeded a threshold amount. If this annual threshold was exceeded, then the maximum expense limitation — $100,000 — was reduced dollar for dollar. The new law increases this threshold amount for expensing from $200,000 to $400,000 through 2007.

Both of these changes are in effect now and both dollar amounts — the maximum expensing limit and the threshold for phase-out — are indexed for inflation. Adjusted for inflation, the deduction and threshold limits for 2004 are set at $102,000 and $410,000, respectively.

•Limit on expensing for sport-utility vehicles: The expensing provisions under the previous law were sometimes used by businesses to provide SUVs to corporate executives without running afoul of limitations imposed elsewhere in the tax law that limited deductions for luxury passenger automobiles used for business purposes. Taxpayers were able to use the $100,000 expensing to deduct most, if not all, of the cost of heavy-duty or top-of-the-line SUVs provided to executives because the existing limitations applied to passenger-type vehicles with a weight of 6,000 pounds or less.

The new law forecloses this opportunity by limiting the expensing deduction to $25,000 for any SUV rated at 14,000 pounds gross vehicle weight or less, subject to various exceptions and is effective for an SUV placed in service after Oct. 22, 2004. The $25,000 limit is not subject to any inflation adjustment.

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•Shorter recovery period for qualified leasehold/restaurant improvements: Under prior law, leasehold improvements to commercial real estate were generally required to be depreciated or written off over a period of 39 years. This rule applied even where the business owner's lease was of a much shorter duration, as is typical for commercial leases.

The new law rectifies this unfairness by now permitting these improvements to be depreciated over just 15 years, using straight-line depreciation. Leasehold improvements that qualify for this shorter recovery period are those placed in service after Oct. 22, 2004, and through the end of 2005 and that are made more than three years after the building has been constructed.

Qualifying improvements made to restaurants also qualify for the shorter 15-year recovery period, provided the improvements are made to the restaurant building more than three years after it is completed and more than half of the building's square footage is devoted to such purpose.

•Organizational/business startup costs: Under prior law, costs incurred to organize a new business organization such as incorporation, legal and accounting fees (organization expenses) or in preparation for starting a new business (startup costs) were not currently deductible. Instead, such amounts were required to be capitalized and the taxpayer could elect to write off such costs, through a deduction for amortization, over 60 months commencing with the month when the organization/business began operations.

The new law changes these rules to permit up to $5,000 of organization costs and up to $5,000 of business startup costs to be currently deducted, provided any remaining amounts are written off over a period of 180 months. The $5,000 limit is reduced dollar for dollar to the extent the cumulative costs — whether or not incurred before the effective date of the new law — exceeds $50,000.

This change applies to organization or startup costs incurred after Oct. 22, 2004. This change favors small-business owners as opposed to larger enterprises because most small businesses will not typically incur more than $5,000 in organization or startup costs, so that most small businesses will now be able to fully deduct these expenses in the year incurred.

In summary, these changes provide some tax incentives for small businesses. Because all these changes are now in effect, they will affect year-end capital investment decisions. Further, because the increase in expensing is scheduled to expire after 2007, small business should consider whether it is prudent to accelerate plans for future capital expenditures, provided the level of such expenditures does not exceed the phase-out threshold, which begins at $410,000 this year.

Whether the increase in expensing will be made permanent by a future Congress remains, of course, uncertain.