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what contractors

The Jobs and Growth Tax Relief Reconciliation Act of 2003 is a tax cut intended to help the economy move toward expansion. Some debate whether the Act can accomplish that intended objective, but most agree that there are positive changes in this new law.
The foundation of the act is to accelerate and extend many of the tax cuts and incentives seen in the 2001 and 2002 tax acts. Consider a few highlights of the new 2003 law:

- Top individual marginal rates are immediately lowered to 35% through 2010 unless made permanent by Congress.
- Capital gains rates temporarily drop to 15% for sales and exchanges after May 8, 2003 through December 31, 2008.
- Certain dividend income received by individuals will be temporarily taxed at a new lower rate of 15% for 2003 through 2008.
- Depreciation deductions are further liberalized and bonus depreciation has been temporarily extended.

And on the negative side:

- The tax act will increase the government's expected deficit and debt level.
- Although there is not the significant structural change that would have occurred if the administration's proposal to eliminate taxation of corporate dividends had been passed as part of this act, the effective dates and sunset provisions of the new changes are voluminous and add more complexity to the tax code.
- The Alternative Minimum Tax (AMT) will continue to haunt smaller contractors as well as many other taxpayers.

Take a look at just a few of the key provisions that will likely affect contractors.

Liberalized Expensing Election

Section 179 of the Internal Revenue Code permits small businesses to expense a certain amount of the cost of tangible depreciable personal property purchased and placed in service in an active trade or business. By deducting the cost of assets immediately rather than depreciating the asset cost over several years, contractors can decrease their tax burden and have more capital available for other business needs.

Under the 2003 Jobs and Growth Act, the following expensing changes are effective for tax years beginning after 2002 and before 2006:

- The maximum annual expensing amount increases from $25,000 to $100,000.
- This maximum annual expensing amount will phase out as the total cost of qualifying property placed in service during the tax year exceeds a specified threshold. The threshold increases from to $200,000 from $400,000.
- The increased dollar amounts will be inflation-indexed for tax years beginning after 2003.
- Off-the-shelf computer software is now eligible for expensing.

This will assist most contractors except those that purchase significantly more than $400,000 annually such as heavy & highway contractors. Note that the new provisions are indexed for inflation but generally expire after 2005.

Bonus Depreciation

In general, under the 2002 Economic Stimulus Package, which was passed March 9, 2002, a 30% additional first-year depreciation allowance can be applied to the non-expensed portion of qualified property if:

- its original use commenced with the taxpayer after Sept. 10, 2001;
- the taxpayer acquired the asset after Sept. 10, 2001 and before Sept. 11, 2004; and
- it was placed in service by the taxpayer before 2005 (before 2006 for certain property with longer production periods).

The 2003 law changes these bonus depreciation rules by increasing the bonus percentage from 30% to 50% bonus for first-year depreciation if:

- the asset's original use commences with the taxpayer after May 5, 2003; and
- the taxpayer acquires the asset after May 5, 2003 and before 2005. (There cannot be a written binding contract for acquisition in effect before May 6, 2003.)

The 30% bonus rate still applies from Sept. 11, 2001 through May 5,2003. Consider the interplay of the Section 179 expensing provisions and the bonus depreciation on the typical contractor:

During 2003, a contractor purchased $250,000 of property that is placed into service on June 1, 2003 (i.e. after the effective date in the Act). This is the contractor's only asset purchase dur-

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By Richard R. Shavell, CPA

ing the year and the property qualifies for an expensing election under Code Section 179 (i.e. assets purchased do not exceed $400,000).

The contractor is first allowed a $100,000 deduction under Code Section 179. The contractor is then allowed bonus depreciation of $75,000, which is 50% of the adjusted basis of $150,000 after the expensing election ($250,000 of original cost, less the $100,000 Section 179 deduction).

The remaining adjusted basis of $75,000 ($250,000 minus $100,000 minus $75,000) is deducted in 2003 and later years depending on its depreciable life. Assume it is 5-year property and the rates apply as follows:

Tax year 2003, $15,000 (20% of $75,000);
Tax year 2004, $24,000 (32% of $75,000);
Tax year 2005, $14,400 (19.20% of $75,000);
Tax year 2006, $8,640 (11.52% of $75,000);
Tax year 2007, $8,640 (11.52% of $75,000); and
Tax year 2008, $4,320 (5.76% of $75,000).

The implication to contractors is significant. On the $250,000 acquisition of assets in the example, the contractor will receive a first year deduction of $190,000 ($100,000 expensing plus $75,000 bonus plus $15,000 first-year depreciation). The impact could be an effective tax savings at 35% of $66,500.

Compare this to prior law before the bonus depreciation rules were enacted. Under those rules, without bonus depreciation, the first year depreciation deduction would be $70,000 ($25,000 expensing under Section 179 plus first-year depreciation at 20% of the balance). At an effective tax rate of 35%, this would be $24,500. Using the numbers in the example, the new law - with the increased bonus depreciation - results in 2.7 times more tax deduction.

The intended implication is that all businesses will have an incentive to purchase new business assets, thereby causing the economy to expand. A concern will be whether taxpayers face tax liabilities so that acceleration of depreciation deductions will, in fact, reduce taxes now.

Reduction of Tax Rates Accelerated

The 2003 Jobs and Growth Package reduces individual tax rates, which should help small businesses. The act includes an immediate reduction of the marginal tax brackets paid by all but the lowest earners. This is of particular interest to all of those businesses structured as S Corporations, Limited Liability Corporations (LLC), and other pass-through entities such as partnerships. Pass-through entities do not pay tax but rather the S Corporation shareholders, LLC Members, and Partners of partnerships pay the tax on their share of the entity's income.

Under the change, the tax rate brackets above the 15% bracket are:

- New Law: 25%, 28%, 33%, and 35%
- Prior Law: 27%, 30%, 35%, and 38.6%.

These reductions had been scheduled to phase in and reach these bracketed rates in 2006. It is important to note that after 2010, rates above 15% are scheduled to revert to the pre-2001 levels (i.e., 15%, 28%, 31%, 36%, and 39.6%). A high-earning taxpayer would then see his effective marginal rate increase from 35% back to 39.6%, which is an 11.6% increment.

But that, of course, is the foundation on which these new laws are based. The economy needs a boost so let's make more tax dollars available to be invested in the growth of businesses and the economy. The end result should be more jobs and a healthier economy.

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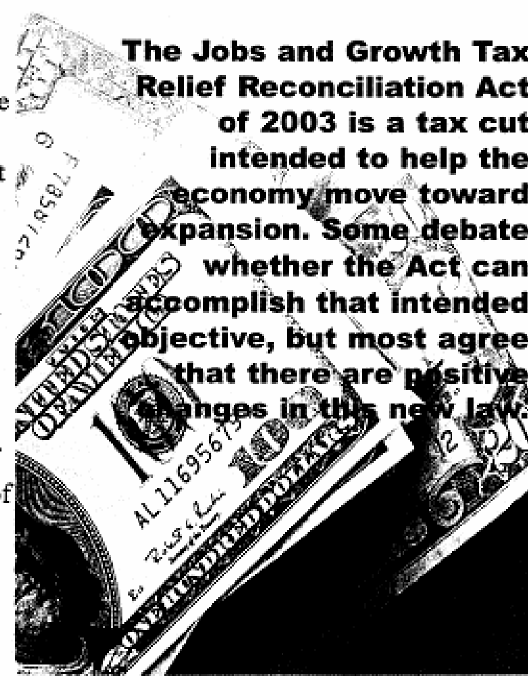

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At the same time, these new laws perpetuate the uncertainty in our tax laws by permitting a voluminous number of rules and rates to face sunset dates in the future. Contractors should take advantage of some of the new rules and incentives before they expire.

Richard R. Shavell, CPA previously served as Chairman of ABC's National Tax Committee and continues to serve as a member of that committee as he has done for the last twelve years. For more information, visit Shavell & Company, P.A., CPAs and Consultants online at www.shavell.net , or call 561-997-7242.