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FAVORABLE EXPENSING AND DEPRECIATION RULES FOR BUSINESSES EXTENDED

On January 2, 2013, President Obama signed into law the American Taxpayer Relief Act of 2012 (the "2012 Act"). Included in the Act were extensions of favorable rules for depreciating and expensing certain business assets that had been in effect in 2011 but were limited in 2012 and set to expire on January 1, 2013. These provisions were described in "2011 Year-End Tax Planning Opportunities for Small Businesses" available here.

179 Deduction. During taxable years beginning in 2012 and 2013, businesses now are allowed to deduct, rather than capitalize, up to $500,000 of the cost of machinery and business equipment, computers, computer software, office furniture and equipment, and certain business vehicles purchased during the year under Internal Revenue Code Section 179 (the "179 Deduction"). The 179 Deduction is available for used property as well as new property and also for off-the-shelf computer software. The 179 Deduction also can be taken on up to $250,000 (of the $500,000 deduction limit) of certain real estate purchases. This category includes qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property (collectively, "Qualified Real Estate"). However, certain limitations remain in place. First, the deduction phases-out as a business spends more than $2 million on qualifying purchases. Second, the deductions cannot be used to cause or increase a tax loss (i.e., the business has to be profitable during the year). All of these provisions had been reduced or eliminated in 2012 and 2013, but all of them have been extended retroactively under the 2012 Act to cover tax years 2012 and 2013. Starting in 2014, the 179 Deduction limit is scheduled to drop from $500,000 to $25,000, the phase-out drops from $2 million to $200,000, and Qualified Real Estate and off-the-shelf software will no longer be covered.

Bonus Depreciation. The 2012 Act also extends into 2013 certain favorable accelerated depreciation rules that were effect in 2012. Business are allowed to depreciate 50% of the cost of new property purchased in 2013 (effectively the same as deducting the purchase price). The property must either be Qualified Real Estate or qualify for depreciation under normal depreciation rules and includes things like buildings, machinery, vehicles, furniture, and equipment, as well as "intangible property" like patents, copyrights and computer software. Bonus Depreciation is not subject to the $500,000/$2,000,000 limitations of the 179 Deduction. Bonus Depreciation will expires in 2014, when the normal depreciation rules go back into effect. Unlike the 179 Deduction, Bonus Depreciation can create a net operating loss which can be carried forward to future years or carried back to prior years (which could result in a refund).

The 179 Deduction and Bonus Depreciation may be combined, but there is an ordering rule for applying these incentives. The 179 Deduction is considered first, followed by Bonus Depreciation, and then by regular depreciation. This can be illustrated by an example in which a business buys two pieces of machinery, one new and one used, for a price of $1,000,000 each. For the new machinery, the taxpayer can claim a 179 Deduction of $500,000 and Bonus Depreciation of $250,000 (50% of the $500,000 cost basis remaining after the 179 Deduction). The remaining $250,000 would be depreciated over a number of years under regular depreciation rules. For the used equipment, the taxpayer would be limited to a 179 Deduction of $500,000, with the remaining $500,000 cost basis depreciated under regular depreciation rules.