

The Business Review Submission

“Small Business Reaps Benefit of 2003 Tax Legislation”

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Small business is the engine driving the economy of the United States. That task may be easier to bear, at least temporarily, as a result of the Federal 2003 tax changes.

The tax legislation signed into law by President Bush on May 28, 2003 represents the third largest tax cut act in U.S. history. A law covering little new ground, the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) lowers existing tax rates, increases current equipment expensing limitations, and accelerates certain tax benefits passed under prior legislation. Small businesses and their owners are key beneficiaries of its changes.

Investment in Fixed Assets

Capital-intensive small businesses will find much to be happy with in the recent legislation. Historically, such companies have struggled as the out-of-pocket cash needed to purchase assets far exceeded the tax savings generated by those purchases. The method by which businesses garner a tax deduction for asset purchases, or depreciation, received special attention in the 2003 Act, specifically to address this cash-flow gap.

- ❑ JGTRRA enhanced the bonus depreciation allowance for certain qualifying property placed in service after May 5, 2003. As a result, new property purchased by a small business will qualify for an elective 50% tax deduction in the year acquired.
- ❑ The so-called “Section 179” expense election has been increased to \$100,000 for 2003. Small businesses acquiring less than \$400,000 in fixed assets annually may qualify for an elective and immediate deduction of their entire year’s investment in fixed assets up to the \$100,000 threshold.

The relief here will be temporary, however, unless Congress acts to extend the provisions contained in JGTRRA. Under current law, the 50% bonus depreciation will generally apply only to property placed in service before January 1, 2005, and the Section 179 amount is slated to return to its pre-2003 level of \$25,000 in 2006. Given the fickle nature of tax law, and the looming Federal budget crisis, small business owners should consider taking advantage of the liberal depreciation rules before the scheduled expirations loom.

Choice of Business Structure

Small business owners have several choices when deciding what legal form their business will take, including corporations, Limited Liability Companies (LLC), or partnerships. Tax considerations play a major role in the decision. Lower tax rates enacted by JGTRRA will impact the analysis when new businesses are formed, and may offer an incentive for small business owners to rethink their existing structure.

- ❑ Tax rates on dividend income received by individuals have been lowered to 15% for most taxpayers through December 31, 2008. Advisors often steer small business owners away from the traditional corporate structure due a potential “double tax” bite; dividends paid by a corporation are not deductible to the corporation, and are taxable to the individual shareholder at ordinary income tax rates, previously as high as 38.6%. The significantly lower rates on dividend income make it much cheaper to get money out of a corporation through 2008.
- ❑ Capital gains also got a rate decrease. Capital gains incurred after May 6, 2003, through 2008 will be taxed at 15% for most taxpayers. Generally, a small business owner selling their stock in a corporation will pay tax at the capital gain rate. However, selling an interest in an LLC or partnership can generate ordinary income, taxable at up to 35%. The time frame of a small business owner’s plans will be key here; the closer their retirement or planned stock disposition, the more relevant this rate reduction will be given its scheduled expiration in 2008.
- ❑ Business forms other than traditional corporations are called “pass-through entities” because the income tax on their annual operations is paid not at the business level, but at the owner’s individual tax rate. JGTRRA accelerated to 2003 individual tax rate reductions that were scheduled to take effect in future years. The lowest individual tax bracket was expanded, and most other tax rates dropped 2%, through 2010. These rate reductions will favor “pass-through entities” such as S corporations, LLCs, and partnerships.

Long-term planning is key here, given the temporary nature of the changes. New business owners should carefully weigh the short-term rate relief within the context of established legal and tax practices. Business owners should not rush to change their existing structure, but rather evaluate the potential savings to be realized from the rate changes.

Nothing lasts forever, especially in tax law. The planning possibilities presented by the passing of JGTRRA are many, but small business owners are cautioned to take the temporary nature of the advantages into account. Some provisions will provide immediate tax relief, while others may be of limited benefit due to the relatively short time before expiration. A small business owner’s ability to balance responsiveness and long-range thinking will aid in taking full advantage of JGTRRA’s changes.