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Tax Trends

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Significant savings from increased depreciation – will it benefit you?

Learn more inside.

Applying the New Bonus Depreciation and Section 179 Rules to Fiscal-year Taxpayers

The Economic Stimulus Act of 2008 added some really generous provisions for businesses, namely, a 50% bonus depreciation deduction and an increased Section 179 deduction of $250,000. We covered these rules in our February 2008 Tax Alert. Generally, these tax breaks are for 2008. But, like usual, the devil is in the details, and things get a little tricky for fiscal-year taxpayers. So, here's the scoop for those who do not use a calendar-year.

Bonus Depreciation Applies to Assets Acquired During 2008

The 50% bonus depreciation provision generally applies to qualifying assets acquired and placed in service in 2008. This means that fiscal-year taxpayers with a year ending in 2008 will only be able to claim bonus depreciation on qualifying assets acquired and placed in service after 12/31/07. However, these filers will also be able to claim a 50% bonus depreciation on their returns for their fiscal-year ending in 2009 (but only for assets acquired on or before 12/31/08).

Please see Applying the New Bonus continued on page 2.

Real Estate Cost Segregation Services

Cost segregation can uncover tax savings hidden within business property. In general, taxpayers are restricted to depreciating the costs of property over 27.5 or 39 years for tax purposes. However, with cost segregation, taxpayers can classify the costs of property differently so that certain building components qualify for much faster depreciation deductions than the rest of the building. In some cases, additions placed into service in 2008 may also qualify for very favorable bonus depreciation deductions. Cost segregation can apply to new construction, acquisitions, renovations or expansions of existing property, major leasehold improvements and real property stepped up through estate or other methods.

Cost Segregation Study

Cost segregation is a sound tax planning strategy for commercial and rental property owners. It begins with a cost segregation study. While there are different methods for performing a cost segregation study, Blum Shapiro uses the engineering method exclusively. The engineering method is the recommended method of the IRS. Tax and engineering professionals work together as a team, personally visiting the property as well as examining blue prints and drawings, specifications and construction documents, estimates and cost data from contractors

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Applying the New Bonus Depreciation and Section 179 Rules to Fiscal-year Taxpayers

Equipment purchases and getting the most from the two tax breaks

Bottom Line: With the limited exceptions noted earlier, bonus depreciation is only available for assets acquired and placed in service during calendar-year 2008. So, fiscal-year filers may be reporting bonus depreciation on two consecutive returns (but only for assets acquired and placed in service during calendar-year 2008).

Fiscal-year filers must use new Form 4562-FY to claim a 50% bonus depreciation for assets acquired after 2007. For a fiscal-year ending in 2008, a 2007 Form 4562-FY (available at **www.irs.gov**) must be used, since the fiscal-year began in 2007.

Increased Section 179 Expensing Applies to Years Beginning in 2008

Unlike the bonus depreciation, which applies to assets acquired and placed in service during calendar-year 2008 (regardless of the taxpayer's fiscal-year), the increased $250,000 limit and $800,000 phase-out threshold for Section 179 expensing is a one tax-year deal and applies to a taxpayer's *tax years beginning in 2008*. Thus, for a fiscal-year filer, assets acquired in 2008 will only qualify for the $250,000 expensing limit and $800,000 phase-out threshold if they are acquired and placed in service during the fiscal-year beginning in 2008 (and ending some time in 2009). For these fiscal-year filers, some assets acquired in 2009 (if before the end of the fiscal-year ending in 2009) will qualify for the $250,000 expensing limit. Assets placed in service during the fiscal-year ended in 2008 (even those purchased in 2008) are subject to the $125,000 Section 179 limit and $500,000 phase-out threshold that applies to fiscal-years beginning in 2007.

Example: Asta Corporation files on a June 30 fiscal-year-end. On 5/15/08, Asta acquired $600,000 of machinery (seven-year MACRS recovery period) that is qualified property for the bonus depreciation rules and eligible for Section 179 expensing. Because the machinery was acquired and placed in service during 2008, it qualifies for a bonus depreciation on Asta's return for the year ended 6/30/08. However, Asta's Section 179 expense deduction for that year is limited to $125,000 and its phase-out threshold is $500,000 because the tax year in which it acquired the machinery started in 2007. Asta's maximum cost recovery deduction for the machinery (assuming no other qualifying Section 179 assets were purchased during its fiscal-year and that the half-year convention applies) is as follows:

Section 179 deduction [$125,000 – ($600,000 – $500,000)]	$ 25,000
50% bonus depreciation [($600,000 – $25,000) × 50%]	287,500
Regular depreciation deduction [($600,000 – $25,000 – $287,500) × 0.1429]	41,084
Total	**$353,584**

Variation: Everything stays the same, except Asta waits until 7/15/08 to acquire and place the machinery in service. Now, the Section 179 limit (for Asta's year ending 6/30/09) is $250,000 and the phase-out threshold is $800,000. The machinery also qualifies for a bonus depreciation, because it is acquired and placed in service during 2008. Asta's total cost recovery deductions for the machinery are as follows:

Section 179 deduction	$250,000
50% bonus depreciation	
[($600,000 – $250,000) × 50%]	175,000
Regular depreciation deduction	
[($600,000 – $250,000 – $175,000) × 0.1429]	25,008
Total	**$450,008**

In this example, waiting a few months to acquire the machinery and place it in service increases the cost recovery deduction by $96,424 ($450,008 – $353,584). But, the deduction is also deferred until the year ended 6/30/09. Also, if the assets placed in service cost less than $125,000, they could be fully expensed during the year ended 6/30/08, and there is no advantage to waiting until the following year to get the benefit of the larger Section 179 deduction.

Here is a handy chart for explaining the different sets of rules that will apply over the next two fiscal-years:

Asset Purchases

1/1/2008 – End of Fiscal-year Ending in 2008

- Bonus depreciation available
- $125,000 Section 179 limit / $500,000 phase-out threshold

Beginning of Fiscal-year Ending in 2009 – 12/31/08

- Bonus depreciation available
- $250,000 Section 179 limit / $800,000 phase-out threshold

1/1/09 – End of Fiscal-year Ending in 2009

- No bonus depreciation
- $250,000 Section 179 limit / $800,000 phase-out threshold

The Section 179 Trap for Fiscal-year Pass-through Entities

The increased $250,000 limit for Section 179 expensing is a one tax-year deal and applies to a taxpayer's *tax years beginning in 2008*. Thus, for fiscal-year filers, assets acquired and placed in service during their fiscal-year beginning in 2008 and ending in 2009 qualify for the increased deduction. This increased deduction then will be reflected on the entity's 2008 return, a 2008 Form 1120S for fiscal-year S corporation or a 2008 Form 1065 for a fiscal-year partnership. So far, so good.

Here's the potential problem, if the increased 179 deduction is then passed out to a calendar-year owner (shareholder or partner), that owner will claim the deduction on his or her 2009 calendar-year Form 1040. As such, it will be subject to the limits in effect for the taxpayer's 2009 calendar-year, probably about $130,000 after inflation indexing.

Allocations in excess of the 2009 limit will be lost, as there is no carryover provision for this excess. For example, if a fiscal-year S corporation claims the full $250,000 Section 179 deduction on its 2008 Form 1120S (for its 2008–2009 fiscal-year) and then passes the full deduction to its sole owner, a calendar-year individual, $120,000 of the Section 179 deduction ($250,000 less the 2009 expected limit of $130,000) will be wasted—it can neither be deducted, nor can it be carried over.

This, of course, isn't a problem if the shareholder or partner is allocated a Section 179 deduction not exceeding their calendar limit. So, the problem will likely only catch majority owners. This is a technicality in the way the tax law was drafted. Unfortunately, it affects only a small number of businesses, and we do not expect that Congress will make a legislative modification to this oversight.

Getting the Most from Both Tax Breaks

Under normal conditions (that is, the goal is to minimize taxable income), the Section 179 deduction should be used first to expense assets that are *not* eligible for bonus depreciation. That maximizes the amount of basis that can be written off under the super-fast Section 179 rules and the pretty-fast bonus depreciation rules. For example, use as much of the Section 179 allowance as possible for used equipment additions that are ineligible for bonus depreciation. Next, the Section 179 deduction should be used to expense assets with longer recovery periods. Again, this maximizes the amount of basis subject to a faster write-off. Bonus depreciation deduction then can be claimed for the remaining basis (after subtracting the Section 179 deduction).

Fiscal-year taxpayers should pay close attention to the dates they acquire assets, since they can't assume that all their new asset purchases that qualify for bonus depreciation will also qualify for Section 179 expensing (and vice versa) due to the different placed in service rules. These taxpayers should time 2008 purchases carefully to make sure they get the best result. For example, a taxpayer planning to acquire a large used asset (that never will qualify for bonus depreciation) might budget that acquisition for its fiscal-year beginning in 2008 (to take advantage of the $250,000 Section 179 expensing limit) and use its acquisitions budget for the fiscal-year ending in 2008 for assets eligible for bonus depreciation.

Conclusion

Here is what you need to remember regarding the 50% bonus depreciation and increased Section 179 limits for 2008. If you file on a calendar-year basis, all is well. But, if you file on a fiscal-year, you will want to focus on the different placed-in-service rules for the two deductions. Please call us if you would like to discuss how these rules will affect you.

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Real Estate Cost Segregation Services

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and asset purchase agreements. As a result, they are able to identify nonstructural, moveable or decorative components that are not part of a building's general operation and make an itemized list of those shorter-lived assets.

By carefully separating and cataloging these assets, 20-40% of the building's costs can be depreciated over 5, 7, or 15 years, producing significant tax savings. The savings are even greater for property placed into service in 2008. The Economic Stimulus Act of 2008 added a 50% bonus depreciation deduction for property placed into service before 12/31/2008. Property qualifying for this deduction does not include property with a tax life greater than 20 years. Therefore through reclassifying the building's costs to lower life property, the costs are now also eligible for bonus depreciation deductions that wouldn't have applied if the study was not performed.

Reclassifying building costs to categories with shorter depreciation lives should NOT increase personal property taxes. Local law defines what is real property or personal property for property tax purposes. Generally, the reclassified costs resulting from a cost segregation study should continue to be taxed as real property for property tax purposes. Thus, it is important to keep track of reclassified property that's depreciated over personal property lives and not report that property on personal property tax forms to avoid double property taxes.

Reporting the Results of the Study

Once the cost segregation service has been performed, the results are incorporated into your income tax returns. If a Cost Segregation study was performed on a building that was placed into service in a prior tax year, it is not necessary to amend any returns previously filed. Instead, a change in the accounting method form is filed along with the tax return subject to certain filing deadlines. By doing this, all of the benefits of the accelerated depreciation from the year the building was placed into service to date are realized in the first tax year of the study. In such situations, deductions missed in prior years can be "caught up" in the year of change without having to amend prior years or wait for IRS approval.

Conclusion

A cost segregation study can help boost your cash flow through dramatic tax savings on new or refurbished buildings. The savings are further supplemented by the 2008 bonus depreciation provision. Please call us if you would like to discuss how a cost segregation study can apply in your situation.

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