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Tax Tips

Accelerating depreciation deductions

A cost segregation study may reduce taxes

Businesses that acquire, construct or substantially improve a building — or did so in previous years — should consider a cost segregation study. These studies combine accounting and engineering techniques to identify building costs that are properly allocable to tangible personal property rather than real property. This may allow you to accelerate depreciation deductions, thus reducing taxes and boosting cash flow.

The basics

IRS rules generally allow you to depreciate commercial buildings over 39 years (27½ years for residential properties). Most times, you'll depreciate a building's structural components — such as walls, windows, HVAC systems, elevators, plumbing and wiring — along with the building. Personal property — such as equipment, machinery, furniture and fixtures — is eligible for accelerated depreciation, usually over five or seven years. And land improvements — fences, outdoor lighting and parking lots, for example — are depreciable over 15 years.

Too often, businesses allocate all or most of a building's acquisition or construction costs to real property, overlooking opportunities to allocate costs to shorter-lived personal property or land improvements. In some cases — computers or furniture, for instance — the distinction between real and personal property is obvious. But often the line between the two is less clear. Items that appear to be part of a building may in fact be personal property, like removable wall and floor coverings, removable partitions, awnings and canopies, window treatments, signs, and decorative lighting.

In addition, certain items that otherwise would be treated as real property may qualify as personal property if they serve more of a business function than a structural purpose. This includes reinforced flooring to support heavy manufacturing equipment, electrical or plumbing installations required to operate specialized equipment, or dedicated cooling systems for data processing rooms.

Although the relative costs and benefits of a cost segregation study depend on your particular facts and circumstances, it can be a valuable investment. For example, let's say you acquire a nonresidential commercial building for $5 million on January 1. If the entire purchase price is allocated to 39-year real property, you're entitled to claim $123,050 (2.461% of $5 million) in depreciation deductions the first year. A cost segregation study may reveal that you can allocate $1 million in costs to five-year property eligible for accelerated depreciation. Reallocating

the purchase price increases your first-year depreciation deductions to $298,440 ($4 million × 2.461%, plus $1 million × 20%).

A cost segregation study can assist you in making partial asset disposition elections and deducting removal costs under the recently issued final tangible property regulations. Consult with your tax advisor about the possible interplay that may prove beneficial depending on your situation.

Look-back studies

If your business invested in depreciable buildings or improvements in previous years, it's not too late to take advantage of a cost segregation study. A "look-back" cost segregation study allows you to claim missed deductions back to 1987.

To claim these tax benefits, file Form 3115, "Application for Change in Accounting Method," with the IRS and claim a one-time "catch-up" deduction on your current year's return. There's no need to amend previous years' returns.

Property and sales tax considerations

You can also use cost segregation studies to support the property tax or sales tax treatment of certain items. For example, you might use a study to document the cost of tax-exempt property. Many states exempt property used in manufacturing, for example.

A word of caution: Certain property may be treated differently for income tax and property tax purposes, and reporting mistakes can lead to double taxation. Suppose your state has a personal property tax and that you reclassify certain building components as personal property for income tax purposes based on a cost segregation study. If you report these items to the state as taxable personal property, but state law treats them as part of the real estate for real property tax purposes, they may be taxed twice: once as personal property and once as real property.

To avoid this result, be sure you have systems in place to track the costs of these items separately for income tax and property tax purposes.

Is it right for you?

Cost segregation studies may yield substantial benefits, but they're not right for every business. To find out whether a study would be worthwhile, ask your tax advisors to do an initial evaluation to assess the potential tax savings. ■

PATH Act enhances benefits of cost segregation study

Last year's Protecting Americans from Tax Hikes (PATH) Act extended or made permanent several tax breaks, some of which enhance the benefits of a cost segregation study. Among other things, the act retroactively and permanently reinstated higher limits on Section 179 expensing. Sec. 179 allows you to immediately deduct the entire cost of qualifying equipment or other fixed assets up to specified thresholds.

The PATH Act also retroactively and permanently reinstated 15-year-property treatment for qualified leasehold, retail and restaurant property, and temporarily extended 50% first-year bonus depreciation (phased out over five years).

By reviving these provisions, the PATH Act enhances the benefits of a cost segregation study that increases the amount of property eligible for these tax breaks.

How basis planning can result in significant tax savings

A basic tenet of estate planning is to minimize gift and estate taxes. Yet with the exemption amount at $5.45 million for 2016 ($10.9 million for married couples), a vast majority of Americans won't have to pay these taxes. For many, this means that estate planning focuses on income tax planning. And one of the most valuable tax planning areas is the "stepped-up basis" rule.

Understanding basis

Generally, your basis in a capital asset is the amount you paid for it, adjusted to reflect certain tax-related items. For example, basis may be reduced by depreciation deductions or increased by additional capital expenditures. For purposes of this article, we'll assume that basis is equal to an asset's original cost.

If you sell a capital asset for more than its basis, you have a capital gain. If you sell it for less, you have a capital loss. Short-term capital gains (on assets held for one year or less) are taxed as ordinary income. For 2016, long-term capital gains are taxed at a maximum 20% rate for taxpayers in the highest bracket (0% for taxpayers in the two lowest tax brackets and 15% for all others). Certain high-income taxpayers are subject to an additional 3.8% tax on net investment income, bringing the capital gains rate up to 23.8%. Keep in mind that state income tax could increase the total tax rate significantly.

If you bequeath an asset to someone through your will or a revocable trust, the rules "step up" the recipient's basis to the asset's fair market value on the date of your death.

Stepping up basis

If you gift an asset, the recipient assumes your basis, triggering capital gains taxes if the recipient later sells the asset. But if you bequeath an asset to someone through your will or a revocable trust, the rules "step up" the recipient's basis to the asset's fair market value on the date of your death. This allows the recipient to turn around and sell the asset income-tax-free.

From an income tax perspective, it's almost always better to hold appreciating assets for life, so your family members or other heirs can take advantage of a stepped-up basis. So why do many view gifting as the preferred method of transferring wealth? The answer stems from a time when high estate tax rates and low exemption amounts made estate tax avoidance the primary concern.

Using an example

Consider this example: In 2014, Jane bought stock for $2 million. In 2016, when the stock's value had grown to $3 million, she transferred it

to an irrevocable trust for the benefit of her son, Thomas. The 2016 gift and estate tax exemption is $5.45 million, so Jane's gift is tax-free. Note that because in this example the gift was made to an irrevocable trust, the trust acquires Jane's basis and there will not be a step-up in basis at her death.

In 2024, Jane dies and the trust distributes the stock, then worth $6 million, to Thomas. He sells the stock and, because he inherits Jane's original $2 million basis, recognizes a $4 million capital gain. Assume that in 2024 the capital gains rate is unchanged from 2016 — 20% for those in the top bracket, plus the 3.8% Medicare tax. Then Thomas pays $952,000 in taxes. (State income tax may affect this number.) But by gifting the stock in 2016, Jane removed it from her estate, avoiding estate taxes on the stock's appreciated value. Assuming Jane's estate was subject to the top tax rate (40%), the estate tax savings totaled $2.4 million (40% × $6 million).

In the example, the estate tax savings eclipsed the income tax cost, so gifting the stock was the better strategy. With today's high estate tax exemption, only the most affluent families are exposed to estate taxes. Unless your estate is (or will be) large enough to trigger estate taxes, transferring appreciated assets at death generally is the best tax strategy.

Reducing taxes

As you can see from the previous example, not knowing the difference between estate planning and income tax planning can lead to unintended tax consequences. Be aware also that, because basis is "reset" at death, it can also result in a step-down. Before you gift low-basis assets, consult your tax advisor. ■

Watch out for the alternative minimum tax

The IRS designed the alternative minimum tax (AMT) to prevent the wealthy from exploiting certain tax breaks to avoid paying their fair share of taxes. Today, however, the AMT ensnares an increasing number of middle-class and upper-middle-class taxpayers. As the end of 2016 approaches, it's a good idea to assess your potential AMT exposure and consider planning strategies that can reduce or eliminate the tax.

What's AMT?

Essentially, the AMT is a parallel tax structure with its own set of tax rates, deductions, credits and exemptions. Each year, IRS rules require you to calculate both your AMT liability and your regular tax liability and pay the one that's higher.

If you pay AMT, you may be entitled to a credit you can use to offset regular taxes in later years when you're no longer liable for AMT. Generally, the rules limit the credit to the amount of AMT generated by deferral items (exercising incentive stock options), and not exclusion items (state and local taxes).

How do you determine AMT liability?

Calculating AMT is a three-step process:

1. **Determine your alternative minimum taxable income (AMTI).** Do this by making certain

adjustments to your regular taxable income and adding back certain "preference items." Preference items that commonly trigger AMT liability include:

- An unusually high number of personal exemptions,
- Substantial state and local income, property or sales taxes,
- Deductible mortgage interest on a loan used for something other than acquiring, constructing or improving a principal residence (such as a home equity loan used to buy a car),
- Tax-exempt interest on municipal private activity bonds,
- Exercise of incentive stock options (the spread between market and exercise price is a preference item),
- Certain accelerated depreciation deductions,
- Substantial miscellaneous itemized deductions, and
- Deductible medical expenses for individuals who aren't at least 65 at the end of 2016, or joint filers where neither spouse has reached 65 by the end of 2016.

2. Subtract your AMT exemption amount. For 2016, the exemption is $53,900 ($83,800 for married couples filing jointly). However, the IRS reduces this amount by 25% of the amount by which your AMTI exceeds a specified threshold — currently, $119,700 for individuals and $159,700 for joint filers. In other words, the exemption disappears after your AMTI hits $335,300 for individuals or $494,900 for joint filers, increasing the risk that you'll be liable for AMT.

3. Apply AMT tax rate if applicable. If the amount calculated in Step 2 is greater than zero, multiply it by the AMT tax rate — for 2016, 26% of amounts up to $186,300 ($93,150 for married individuals filing separately) and 28% of amounts in excess of that threshold.

What about planning strategies?

If you expect your AMT to be higher than your regular tax in 2016, there may be opportunities to reduce your AMT liability. This includes:

- Deferring state taxes or other expenses that aren't deductible for AMT purposes,
- Postponing the exercise of incentive stock options,
- Investing in tax-exempt municipal bonds other than private activity bonds, and
- Paying off home equity loans.

Also, consider strategies for reducing your income to avoid the AMT exemption phaseout. This can include increasing your tax-deductible contributions to 401(k) plans or other retirement plans, or postponing recognition of large capital gains or qualified dividends. Note that capital gains and qualified dividends are entitled to preferential tax rates under AMT, just as they are under the regular tax regime. But they still count as income for AMT purposes, so they can push your AMTI into exemption phaseout territory, increasing your AMT liability.

Estimate your AMT liability

If you think you may be at risk for AMT, ask your tax advisor to do a preliminary assessment. If AMT liability is likely, you still have time to implement the planning strategies discussed in this article. ■

Tax Tips

Increase withholding to avoid underpayment penalty

Do you file your tax returns as a sole proprietor, partner, S corporation shareholder, self-employed individual or some combination of these? If so, and if you expect to owe $1,000 or more in taxes, you must make quarterly estimated tax payments. If you're behind on these payments, consider catching up through increased withholding between now and the end of the year. You can withhold extra taxes from your own salary or year-end bonus or from your spouse's salary or bonus if you file a joint return.

Why not simply make larger estimated tax payments later in the year? Because the IRS will impose penalties if you underpaid in the first part of the year. In contrast, amounts you withhold from your paychecks (or your spouse's paychecks) are treated as if they were paid ratably over the course of the year, regardless of when they're actually paid. ■

Can your business defer taxes on advance payments?

Accrual-basis businesses that receive advance payments this year for goods or services provided next year may have an opportunity to defer this revenue. Deferral may be available if your business receives advance payments for the use of intellectual property or software, certain guaranty and warranty contracts, subscriptions, memberships in organizations, or hotel facilities or other property in connection with providing services.

You can defer advance payment revenue for one year, but only to the extent it's reported as such on an "applicable financial statement" — that is, one that's audited or filed with a government agency, such as the SEC (but not the IRS). If you don't have an applicable financial statement, you may still qualify for deferral if you have a reasonable method for demonstrating that advance payments received this year aren't earned until next year.

For sales of gift cards or gift certificates, you may be eligible for a two-year deferral of the unredeemed portion if certain requirements are met. ■

Make the most of year-end gifts

If you plan to make year-end gifts to your loved ones or to charity, carefully consider the form of those gifts. For example, if you give appreciated assets to a family member in a lower tax bracket, gain on the sale of those assets will, except in certain situations where the "kiddie tax" applies, be taxed at a lower rate. If you donate appreciated assets to charity, capital gains taxes are eliminated altogether.

Avoid giving assets that have declined in value. You're better off selling them, enjoying the tax benefits of the loss, and using cash or other assets for gifts. ■

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