

2008 ECONOMIC STIMULUS ACT - INCENTIVES FOR NEW CONSTRUCTION

Great news for taxpayers who are embarking on a new construction project or are adding leasehold improvements in 2008 - the Economic Stimulus Act of 2008 was officially signed into law on February 13, 2008, and with it, 50% bonus depreciation is back for a limited time.

Under the new law, taxpayers qualify for a 50 percent first-year bonus depreciation on certain types of property for the current tax year. As it relates to any building construction expenditures, the majority of these benefits can only be identified through the use of a cost segregation study.

The act also includes a substantial increase in the maximum amount of \$179 that can be expensed.

By learning how the latest tax rules work, building owners and tenants in the process of construction can significantly decrease their tax payments.

50% BONUS DEPRECIATION

Congress has used bonus depreciation in the past to encourage business investment for brief periods of time. For example, bonus depreciation was available immediately after September 11, 2001 as well as for certain property used in the New York Liberty Zone or the Gulf Opportunity Zone.

The rules behind bonus depreciation can be complex. Much of the eligibility for additional tax deductions from bonus depreciation is based on when a binding contract was signed and not necessarily when construction has started. With the recent changes, taxpayers can claim an additional 50 percent first-year depreciation deduction on certain assets where construction started between December 31, 2007 and before January 1, 2009. Refer to the sidebar for more details on the rules.

INCREASED \$179 EXPENSING:

In addition to bringing back bonus depreciation, the \$179 limit is nearly doubled, so the maximum amount that businesses can write off under \$179 goes from \$128,000 to \$250,000 during 2008. The Economic Stimulus Act of 2008 also raises the phase-out threshold from \$510,000 to \$800,000 for 2008. That means once a taxpayer has added more than \$1,050,000 in qualifying property, they have no \$179 deduction. No other changes were made to the existing rules applicable to \$179.

The new law makes no changes to the general rules for the types of property that are eligible for expensing. Generally, the property must be tangible personal property, which is actively used in the taxpayer's business and for which a depreciation deduction would be allowed. The property must be used more than 50 percent for business and must be purchased during 2008. The existing exception for computer software also applies to the enhanced expensing amounts under the new law.

Economic Stimulus Act of 2008 50% Bonus Depreciation Provisions

- In order to qualify, the original use of the property must begin with the taxpayer and must occur after December 31, 2007, and before January 1, 2009.
- The property must be purchased and placed in service in 2008. If the property is purchased or constructed under a binding contract before January 1, 2008, it is not eligible for bonus depreciation.
- The property must have a depreciable life under 20 years (under GDS, General Depreciation System)
- The taxpayer must use the bonus for both GDS and AMT.
- Water utility property qualifies.
- Computer software is included, with the exception of software covered by § 197(purchased as part of a business).
- Qualified Leasehold Improvements (QLI)** are included – QLI are depreciated as real property (39 or 15 years) after the bonus depreciation is taken.
- Qualified Restaurant Improvements are not included.
- Property depreciated under the Alternative Depreciation System (ADS) is excluded from bonus depreciation.

***Qualified leasehold improvements are improvements made by lessees, sub-lessees or lessors in a lease between unrelated parties to an interior portion of a nonresidential building. The improvements must have been placed in service by any taxpayer more than three years after the date the building was first placed into service. Improvements made to enlarge a building or to change a building's structural framework do not qualify.*

ENHANCE YOUR SAVINGS WITH COST SEGREGATION:

Cost segregation studies reclassify a substantial portion of a building project from 39 years (or 27 1/2 years in the case of residential income properties), into five-, seven- and fifteen-year property. In addition to the normal accelerated deductions this creates, the assets also become eligible for bonus depreciation. Therefore, taxpayers constructing or remodeling buildings have even more incentive to have an engineering-based cost segregation study performed. The study will help the taxpayer take full advantage of the bonus depreciation rules by identifying every constructed asset that qualifies for the shorter depreciation periods, such as certain millwork, special electrical connections and certain exterior land improvements.

THE BOTTOM LINE:

To illustrate the tax savings, consider \$100,000 of 39-year property that provides a \$1,282 tax deduction in the first year. If a cost segregation analysis were to reclassify this \$100,000 into five-year property, the resulting tax savings would be twofold. By making the property eligible for bonus depreciation, up to 50 percent can be deducted in the first year, allowing for a deduction of \$50,000. The shorter tax life allows for an additional first-year deduction of \$10,000, bringing the grand total in first-year tax deductions to \$60,000 compared to \$1,282 without the study. That is a 4,580 percent increase in first-year tax deductions! This can be further enhanced by the increased 179 deduction as well.

QUALIFIED LEASEHOLD IMPROVEMENTS:

While the benefit to building owners are clearly substantial, landlords and tenants in the process of constructing interior leasehold improvements stand to reap even greater benefits from the new bonus depreciation rules.

Qualified leasehold property does not include improvements that increase a building's length, width or height. Qualified leasehold property also doesn't include any elevator or escalator, any structural component benefiting a common area or the internal structural framework of the building. Additionally, the leasehold improvement would have to be completed more than three years after the original building's construction completion date. As long as the above criteria are met, even qualified leasehold property with a tax life of 39 years may qualify for the first-year bonus depreciation deduction. Unlike new construction, a cost segregation study is not required to take advantage of bonus depreciation. For example, if \$100,000 of 39-year property were to qualify for the 50 percent first-year bonus depreciation, the resulting first-year tax deduction would be \$50,641.

WHY YOU NEED A SPECIALIST

Cost segregation specialists do not replace the essential role the CPA plays in tax planning and preparation, rather the two complement each other. For both new and existing properties, the IRS prefers that engineering-based studies be performed. Cost segregation utilizes a unique combination of construction estimating and tax expertise to properly dissect construction information, compute estimates, and identify subcomponent costs. For new construction, a review of construction invoices alone is not sufficient and for existing properties,

construction cost information is frequently not available or is incomplete. Cost segregation firms focus on providing these services and therefore have the in-house expertise necessary to prepare the study and the detailed supporting documentation in accordance with IRS regulations. Once the study is complete, the CPA will file the schedule and for those owners whose property has been in service for a year or more, they will need to prepare and file Form 3115. An understanding of the benefits of cost segregation and an affiliation with a cost segregation provider can prove to be invaluable to a client's overall portfolio, as well as to the CPA firm itself. However, there are a number of tax issues to consider before a recommendation can be made to perform a cost segregation study, so a knowledgeable CPA should assess the specific situation of each client to determine if a study would be beneficial.

ACT NOW:

The incentives included in the new law can result in substantial benefits for property owners, but they are limited to the current tax year. Taxpayers in the process of construction should take full advantage of the bonus depreciation rules by having a cost segregation study performed to further decrease their tax liabilities and increase their cash flow.

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In addition to being one of the leading educators in the field of Cost Segregation, KBKG specializes in performing engineering-based Cost Segregation studies that allow commercial property owners to depreciate their building in the shortest amount of time permissible under existing tax laws. Since 1999, KBKG's tax and engineering professionals have performed thousands of studies nationwide, satisfying the "13 Principle Elements of a Quality Study" as outlined by the IRS.