



## Contractors can get started implementing year-end tax strategies now

by Scott Johnson, [sjohnson@bkd.com](mailto:sjohnson@bkd.com) & Mark Wilkerson, [mwilkerson@bkd.com](mailto:mwilkerson@bkd.com)

As 2008 draws to a close, it is important to review with your advisor your company's financial position and potential opportunities to take advantage of year-end tax planning. Due to changes in the economy, year-end strategies previously used may not be suitable for the current year. The following ideas should be considered and discussed with your tax advisor to determine which year-end strategies are appropriate to implement.

### Accounting method

What method of accounting does your company use for income tax purposes? This is a key issue when performing year-

end tax planning. While the percentage-of-completion method is generally the standard for financial reporting, there are a number of methods available for income tax purposes depending on a company's size and work the company performs, *i.e.*, cash, accrual, completed contract, percentage-of-completion method, etc.

Review your company's method of accounting and discuss it with your tax advisor to determine if another method is available to better manage cash flow and the timing of income taxes.

### Alternative minimum tax

It is vital to consider alternative minimum tax (AMT) when performing year-end tax planning. AMT is an alternative method of calculating taxes. It

uses certain adjustments to regular taxable income to arrive at alternative minimum taxable income. The most common adjustments for AMT are accounting for long-term contracts (percentage-of-completion method of accounting is required for AMT) and depreciation of fixed assets.

### Deferring income

Contractors using the percentage-of-completion method of accounting may consider deferring additional costs on projects until after year-end. This will reduce current year income recognition.

Contractors using the completed contract method of accounting may consider slowing the progress or completion of a contract late in the year to defer the revenue to future years. However, contractors not using the percentage-of-completion method of accounting must be aware of potential AMT implications since the percentage-of-completion method of accounting is required for AMT purposes.

### Bonus depreciation

The *Economic Stimulus Act of 2008* provides an additional bonus depreciation deduction of 50 percent of the adjusted basis of qualified property. Qualified  
*continued on page 3*

## Consider a cost segregation study to save tax dollars on properties sold

by Phil Jones, [pjones@bkd.com](mailto:pjones@bkd.com)

Commercial and residential real estate owners should consider the tax savings benefits that cost segregation studies can provide. Real estate owners are often unaware of the potential tax savings when they sell their property. If you sold your property and weren't aware of the tax savings at that time, it may not be too late to take advantage of cost segregation.



Gain on the sale or disposition of depreciable real estate is generally equal to its cost basis reduced by the greater of the depreciation claimed on the property or the depreciation that was allowed to be claimed. If you used an impermissible method of depreciation on your property (such as depreciating a parking lot or carpet over 39 years) that resulted in insufficient depreciation deductions,  
*continued on page 4*

### Inside

**2** Giving real estate may ease future tax burden

# Giving real estate may ease future tax burden

by Doug Mueller, [dmueller@bkd.com](mailto:dmueller@bkd.com)

**F**or many people, the prospect of paying estate taxes is pretty low on the priority list but is a looming concern that gets larger every passing year. There are several ways to minimize your future estate tax burden, but we'll focus on only one in this article: making lifetime gifts to remove the assets from your taxable estate.

Most people are afraid of death, but others are more afraid of running out of money before they die. Those concerned about outliving their cash flow can find it very difficult to give liquid assets, such as cash, stocks or bonds, to their heirs.

Another option is to give real estate. In addition to not being a liquid asset, real estate may be one of the largest assets that can be removed from someone's estate. With estate taxes likely to be in the 45 to 55 percent range for the near future, removing a large asset from your estate can have a lot of appeal.

## Power of annual gifting

Under current law, everyone can give \$12,000 cash annually to anyone they choose without making a taxable gift. When combined with your spouse, that's \$24,000 a year that can be removed from your estate and given to each recipient. For example, if mom and dad each give \$12,000 to son, daughter-in-law, daughter and son-in-law, that's \$96,000 each year that is not subject to estate tax at the parents' death. In addition, currently everyone can give \$1 million during their lifetime without paying gift tax.

While this may sound great so far, there are many pitfalls associated with gifting interests in real property and all these must be reviewed.

For the purposes of this article, we'll assume the gift is *not* someone's primary residence. While this can be done, these gifts open a very large series of questions and issues that are beyond the scope of this introductory article. Therefore, we'll assume the gift is of other real estate that is not a personal residence and that there is no mortgage on the property.

## Complications

Here's where giving real estate is a little more complicated than giving cash. It's easy to know the value of the cash you're giving but not as easy when it comes to real estate. How do you give \$12,000 worth of a building? How do you know how much of it to give?



To start, you will need to have the building appraised or expect IRS challenges to the value of the gifted property. Have it appraised near the time of the gift, not in response to the IRS challenge, to get the most benefit. It's also likely you will need multiple appraisals if you plan to give the building over a number of years. You also need to record new deeds each year and work with attorneys to accomplish all this.

In addition, as contrasted with annual cash gifts, the IRS may challenge the transfers as not qualifying for the annual \$12,000 gift exclusion, particularly if the property is not currently producing income.

Also, the transfer of a partial interest in property can create a "co-tenancy"—a very complicated and potentially messy way to own property that is subject to a lease. For these and other reasons, a gift of a partial interest in real property is probably *not* the best way to make gifts.

## Ways to make it easier

Simpler ways to accomplish the same objectives would be:

- ✓ Using a partnership or limited liability company (LLC)
- ✓ Selling the property to the next generation and forgiving the debt over time

If we assume the property is valued at \$240,000, you could convey the entire property at once and not worry about future appraisals and deeds. You simply take back a series of \$24,000 promissory

notes from the intended donee—equal to the amount of the annual exclusions. Each year you forgive one of the notes until all the notes are extinguished. Interest on the notes would need to be paid. This can be a much simpler way to convey the real estate and get it out of your estate.

Alternatively, you could form an LLC and transfer real estate worth \$240,000 into the LLC in exchange for LLC units. Only one deed is needed to record the initial transfer. All gifts are then made in the form of LLC units and not undivided parcels needing separate deeds. The LLC as a real estate ownership structure also provides other value, making this an even more attractive approach. The number of LLC units given each year would vary based on available discounts for the LLC and the value of the units themselves, which would move with the changing value of the real estate.

## Downsides to lifetime gifts of real estate

Some of the downsides to giving lifetime gifts, including real estate, are that the recipient's basis in the property, if they were to sell it, is your adjusted basis. Depreciation recapture on the sale could also be taxed at higher rates. If the property were held until it passed through your estate, the recipient would receive a "step up" in basis to the value of the property when you passed away. That "step up" in basis could minimize gains when the recipient disposes of the property.

## Conclusion

Before you make any gifts of real estate, analyze whether you think the property will be held or sold, determine the current tax basis of the property, whether any discounts would be available if certain ownership structures are used, whether the property is likely to appreciate, whether it is leased to third parties and if the real estate parcel is the right asset to use.

As always, you should discuss any tax matters, including gifting strategies, with your BKD advisor. ■

# Get started implementing year-end tax strategies . . .

*continued from page 1*

property generally includes most types of property (excluding buildings) placed in service after December 31, 2007, and before January 1, 2009. Original use of the property must begin with the taxpayer qualifying. The additional bonus depreciation deduction is allowable for regular tax and AMT purposes. If your company plans on purchasing new machinery in the near future, consider purchasing the machinery prior to year-end to take advantage of tax savings produced by the additional bonus depreciation.

Additionally, certain property with a long production period and certain aircraft placed in service prior to January 1, 2010, may qualify for the additional bonus depreciation deduction. Specific conditions must be met to qualify. If your company has this situation, contact your tax advisor immediately to discuss and determine the appropriate actions necessary for qualification.

## Section 179 expense

Internal Revenue Code Section 179 provides for expensing \$250,000 of eligible business property acquired and placed in service during 2008. Generally, the business property needs to be tangible personal property or off-the-shelf computer software. In addition, the expensing allowance is phased out dollar for dollar by the amount of eligible property placed in service which exceeds \$800,000. The expensing election is allowable for regular tax and AMT purposes.

For tax years 2009 and 2010, the allowable Section 179 expense is \$125,000 and the phase-out begins at \$500,000. For years beginning after 2010, the allowable expense is reduced to \$25,000 with the phase-out beginning when eligible property placed in service exceeds \$200,000.

## Luxury automobile limits

Under the luxury automobile rules, limits are placed on otherwise allowable depreciation deductions for business autos, light trucks and minivans. The first-year depreciation limit is \$2,960 for autos and \$3,160 for light trucks and

vans. The *Economic Stimulus Act of 2008* increased the otherwise applicable first-year limit by \$8,000 (\$10,960 for autos and \$11,160 for light trucks or vans) for qualifying vehicles.

## Cost segregation study

Cost segregation generates cash tax savings by identifying costs imbedded in a building's construction or acquisition cost that qualify for a shorter depreciation period (*for more on cost segregation studies, see page 1*). The identifiable costs are segregated from the building's cost and depreciated over 5, 7 and 15 years instead of 39 years. You can achieve significant tax savings using a cost segregation study in various situations, including new buildings currently under construction, renovation or expansion of existing buildings and purchases of existing properties.

Additionally, a cost segregation study can be performed on post-1986 real estate construction, building acquisitions or improvements where no cost segregation study was performed (even though the statute of limitations previously closed on the property construction/acquisition year). Under current Internal Revenue Service rules, depreciation deductions that you did not claim in a prior year because of erroneous property classifications can be deducted prospectively in one year.

## Qualified production activities deduction

A deduction was created for qualified domestic production activities by the *American Jobs Creation Act of 2004*. For 2008 and 2009, businesses can deduct 6 percent of the lesser of income from qualified production activities or taxable income. Additionally, the deduction is limited to 50 percent of wages paid during the year. The deduction is available for regular tax and AMT purposes.

## Cash-basis method for prepaid expenses

Tax regulations allow for the immediate expensing of certain prepaid expenses, including insurance premiums, warranty and service contract costs and taxes, licenses and permits. The following conditions must be met for the prepaid expenses to be immediately expensed for

tax purposes. First, the benefit cannot extend beyond 12 months. Second, the benefit cannot extend beyond the year following the year of payment. Third, a legal liability to make the payment must have existed in the year paid.

## Bonus payments

The deductibility of bonus payments differs based on an entity's structure. An accrual-basis corporation can deduct bonus payments accrued on its financial statements and paid within two and a half months of year-end. However, accrued bonus payments to a more than 50 percent owner of the corporation (2 percent for S corporation shareholders) are not deductible in the current year even when the payment is made within two and a half months of year-end. Therefore, consideration should be made to pay shareholder bonuses by year-end instead of accruing to obtain a current year tax deduction.

## Low-income housing credit & rehabilitation credit

Prior to the *Housing Assistance Tax Act of 2008*, business tax credits generally could not offset AMT liability. However, the new act provides for low-income housing tax credits and rehabilitation credits to offset AMT liability. Low-income housing credits attributable to buildings placed in service after December 31, 2007, and rehabilitation credits attributable to qualified rehabilitation expenses incurred after December 31, 2007, are eligible. The new act accomplishes this credit offset by treating the AMT as being zero for determining the tax liability limit for the credit.

## Additional items

Review small tool purchases made during the year; if the cost of the tools as a total was high, but the cost of each individual tool was low, consider expensing the tools instead of capitalizing.

For C corporations, consider discussing with your tax advisor the benefits of electing S corporation status for future years. ■

## Consider a cost segregation study to save tax dollars . . .

*continued from page 1*

you may be able to request a change in accounting method to claim the additional allowable depreciation either on an amended or original return. Claiming the full amount of allowable depreciation can save tax dollars over the life of your real estate investment, including the opportunity for significant tax savings at the time of sale.

### ***The IRS now allows a taxpayer to file a request for change in accounting method on a property that has been sold.***

Generally, if an owner has adopted a method of accounting for depreciation, a change in depreciation can be made only by obtaining consent from the Internal Revenue Service. The IRS has specific procedures for obtaining this consent, which is often automatic.

Until recently, a taxpayer who sold a depreciable asset without having claimed the full amount of allowable depreciation could not request an accounting method change unless the taxpayer owned the property at the beginning of the year in which the change was requested.

The IRS now allows a taxpayer to file a request for change in accounting method on a property that has been sold. A taxpayer may do so in the year of sale or prior to the expiration of that year's statute of limitation.

Why consider a cost segregation study for a property that has been sold? First, individuals, or individuals who own interests in S corporations or partnerships, receive a tax benefit on depreciation deductions at ordinary income tax rates. Individuals paying tax at the highest federal tax rate save 35 percent in federal taxes for each dollar of additional depreciation deduction. When the property is sold, however, all or a portion of the gain may be taxed at the lower 15 percent or 25 percent capital gains rate. The tax savings resulting from this differential between the 35 percent tax benefit from the depreciation deductions and the lower capital gains tax rates that apply upon sale is a permanent tax savings to the owner and can be significant.

Individual owners will have their own specific tax situations which may substantially increase or decrease the actual tax savings available. However, take note: preferential capital gains rates currently do not apply to C corporations.

If the statute of limitations is open

for the year of sale, an engineering-based cost segregation study may still be performed. Careful consideration of an owner's tax situation would be required to determine the potential for tax benefits.

If you would like to explore whether a cost segregation study will help you save current or prior year federal and state income taxes, please contact your BKD advisor to discuss your specific facts and circumstances. ■

### **About BKD Blueprint**

This newsletter's content is written by qualified, experienced BKD client service professionals; however, to apply specific information to your situation requires careful consideration of all the facts and circumstances. **Consult your BKD advisor before acting on any matter covered in this newsletter.**

To change your mailing information, email your instructions to [newsletters@bkd.com](mailto:newsletters@bkd.com) and include the code that appears above your name on the mailing label. To add your name to our mailing list, contact a sales & marketing specialist at the BKD office nearest you. To inquire about information in this newsletter, contact your BKD advisor.

E-subscribe to *Blueprint* by following the simple online sign-up instructions at [bkd.com/enews/](http://bkd.com/enews/). BKD will never sell your email address and other personal information to vendors or share it with anyone outside BKD.

© 2008 BKD, LLP.  
All rights reserved.

**Praxity**  
MEMBER  
GLOBAL ALLIANCE OF  
INDEPENDENT FIRMS

Address Service Requested

For a complete list of our offices and subsidiaries and their contacts, visit [bkd.com](http://bkd.com) or contact the sales & marketing specialist at the BKD office nearest you.

P.O. Box 1900  
Springfield, MO 65801-1900

**BKD**  
LLP  
CPAs & Advisors