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NEWSLETTER

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Maximizing Real Property Depreciation Deductions Using Proper Cost Allocations

With the real estate market "heating up," we thought we would offer some comments about depreciating real estate. Increasing depreciation deductions for improved real property can reduce taxable income, without any additional cash outlay. Consequently, cash flow is also increased, because of reduced income taxes resulting from reduced taxable income. When improved investment properties such as apartment buildings, office buildings, or shopping centers are acquired, taxpayers often fail to allocate the purchase price in a manner that maximizes the property's depreciation deductions.

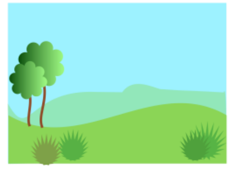
The most obvious means of maximizing depreciation deductions is to allocate as little cost as possible to nondepreciable land. Taxpayers generally accomplish this goal by allocating as much tax basis as possible to the building. However, with depreciable lives of real property spanning 39 years for nonresidential and 27.5 years for residential properties, simply allocating cost between land and building may be only a starting point. A further analysis of the cost often allows a taxpayer to assign shorter depreciable lives to various components or improvements of the property. This additional analysis can significantly accelerate the depreciation deductions.

A three-step process of allocating costs enables a taxpayer to assign as much cost as possible to depreciable property, including property with recovery periods that are much shorter than the MACRS 39-year and 27.5-year lives normally assigned to real property. The three steps are as follows:

- Making an initial land-to-building cost allocation.
- Identifying land improvement costs.
- Analyzing building costs to potentially identifying components with shorter depreciable lives.

The extent to which these steps are performed and the expertise of those doing the analysis depends on the type and cost of the property involved. Using qualified appraisers to perform the analysis is preferred, for more costly properties, and are more likely to withstand an IRS challenge. At the same time, the tax savings associated with the additional depreciation claimed or the acceleration of depreciation deductions should significantly exceed the cost of the analysis. In some cases where the cost of the analysis is not justified, the taxpayer can use a reasonable allocation, if it can be supported. For example, if there is uncertainty regarding the FMV of the land and improvements, the basis might be allocated according to their assessed values for real estate tax purposes.

Making the Initial Land-to-Building Cost Allocation



The first step to maximizing depreciation deductions is to make an initial cost allocation between land and building. The allocation should be based on relative FMVs.

Absent a qualified appraisal, taxpayers can use any reasonable method, provided it is realistic and supportable. For example, the appraisals of local tax assessors, estimated replacement cost, and the taxpayer's own expertise and knowledge have all been held to support the allocation claimed. However, the IRS has ruled that a taxpayer may not allocate cost basis to land and building solely on property tax assessed values when better evidence exists to determine the FMV of each.

This initial allocation is critical, in that it will establish the amount that may be depreciated. Thus, any shift from nondepreciable land to building or other depreciable property results in a permanent increase in the amount of depreciation that can be claimed on the property.

Identifying Land Improvement Costs

Under MACRS, land improvements are depreciated using 150% declining balance over a 15-year recovery period. This recovery period is less than half that used for nonresidential real property and the method more rapid than straight-line, so depreciation can be accelerated to the extent it can be shifted from building to land improvements. More significantly, the extent to which land cost can be allocated to land improvements provides a permanent increase in the amount of depreciation that will be claimed.

Land improvements includes such assets as sidewalks, roads, drainage facilities, bridges, fences, landscaping, and shrubbery.

Only landscaping (e.g., shrubbery, trees, land preparation) adjacent to the building is depreciable, since replacement of the building would destroy this landscaping. Landscaping around the perimeter of the land tract is not eligible for depreciation. Presumably, driveways, parking lots, artificial lakes, retaining walls, embankments, and the like may also qualify as land improvements.

An example can provide some insight:
Thomas Henderson purchased an office building that he will hold and lease as investment property. He paid $5 million for the land and building, which in the sales contract was allocated $1 million to land and $4 million to building based on relative FMVs. If Thomas simply uses the allocation provided in the sales contract, he will depreciate the $4 million of cost allocable to the building using the straight-line method over a 39-year recovery period.

A closer examination of the specific assets acquired and an analysis indicates that some of the cost can be shifted to other classes of depreciable assets. To accommodate certain tenants, the building includes some specialized electrical wiring and plumbing. The analysis results in the following cost allocation:

Description	Land	Land Improve-ments	Building	Personal Property
Land	$820,000	$ -	$ -	$ -
Sidewalks		25,000		
Landscaping		25,000		
Parking lot		100,000		
Fencing		30,000		
Structure and structural components			3,200,000	
Carpeting				50,000
Removable partitions				120,000
Specialized plumbing				200,000
Specialized electrical				400,000
Removable floor and wall coverings				30,000
	$ 820,000	$ 180,000	$ 3,200,000	$ 800,000

Based on this cost analysis, Thomas has shifted $180,000 of nondepreciable land costs to land improvements, which are depreciated over a 15-year recovery period. In addition, $800,000 of the building cost has been identified as tangible personal property, depreciable over a seven-year recovery period. Thus, the cost analysis not only accelerated depreciation on $800,000 of the cost assigned to the building, but it also identified another $180,000 in land improvement costs eligible for depreciation.

Note: For tax years beginning after December 31, 2015, air conditioning and heating units are now eligible for Section 179 expense.

Potential Pitfalls of Cost Segregation

While cost segregation can shorten an asset's depreciation life, this tax benefit should be weighed against the potential pitfalls. These pitfalls can include, but are not limited to, the following:

- When the asset is sold, any depreciation recapture may be subject to ordinary tax rates on Section 1245 property (personal property), rather than at the maximum 25% rate available for Section 1250 property (real property).
- Like-kind exchanges may be more difficult since property must be grouped according to kind or class.

As you can see, paying attention to cost allocations related to improved real estate can provide significant tax benefits.

If you have any questions regarding any of the items mentioned in our article, please give us a call.

Identifying Qualifying Children for Tax Purposes

As you file your 2016 income tax return, you may be wondering whether you're eligible for tax breaks related to a niece who lives with you, or perhaps a stepson who spends only part of the year in your home. It all depends on whether, for federal tax purposes, that person is your "qualifying child."

Widely applicable

In an effort to simplify the tax code and eliminate confusion, Congress established a uniform definition of "qualifying child" as part of the Working Families Tax Relief Act of 2004. The definition applies for purposes of several child-related tax benefits, such as:

- Dependency exemptions
- The child tax credit
- The child and dependent care credit
- Head-of-household filing status

The definition relies on residency rather than requiring that you have provided more than half of a dependent's support, as was the case years ago.

Four tests to pass

More specifically, a qualifying child must meet four tests:

- ***Relationship.*** The definition applies to your child (including one who's adopted or who's an eligible foster child), stepchild, brother, sister, stepbrother or stepsister. It also includes any of their descendants. So, for example, your grandchildren, nieces and nephews also qualify.

- ***Age.*** A child must be under age 13 when the care was provided to qualify for the child and dependent care credit, under age 17 (as of the end of the year) for the child credit and under age 19 (age 24 for a full-time student) for the other tax benefits. Except for the child credit, there's no age limit for a permanently disabled person.

- ***Residence.*** The child must share your principal place of abode for more than half the year, which includes time spent away from home because of school, military service or illness.

- ***Support.*** It's no longer necessary for you to provide more than half of a child's support. But the qualifying child generally can't provide more than half of his or her own support.

Under the current definition, the child must be a citizen or resident of the United States, Canada or Mexico to qualify. However, if the child files a joint return, he or she won't qualify. If more than one person claims a benefit with respect to the same child, the tax code specifies who's entitled to tax benefits.

If two or more people are eligible to claim the same child as a dependent, they can decide among themselves who will claim the tax benefits. In the event that more than one person actually claims those benefits, there are a variety of rules in place to break the tie.

2017 Corporate Annual Reports

All Florida corporate annual reports must be filed on-line at www.sunbiz.org. Online payments may either be made via credit/debit card or check. If you choose to pay the fee by check, you will be able to print out a payment voucher after filing the report online. You then mail the voucher with your check.

Please contact our office if you have any questions or require any assistance with filing your corporate annual report.

What happens if I pay don't pay/file before May 1st?

- A $400 late fee will be imposed on all profit corporations, limited liability companies, limited partnerships and limited liability limited partnerships.
- Non-profit corporations are not subject to the $400 late fee.

TAX CALENDAR

MARCH & APRIL 2017

MARCH 2017

March 10
Employees who work for tips - if you received $20 or more in tips during February, report them to your employer. You can use Form 4070.

March 15
S Corporations - File a 2016 calendar year income tax return (Form 1120S) and pay any tax due. Provide each shareholder with a copy of Schedule K-1 (Form 1120S), Shareholder's share of Income, Deductions, Credits, etc., or a substitute Schedule K-1. If you want an automatic 6-month extension of time to file the return, file Form 7004 and deposit what you estimate you owe.

Partnerships CHANGE – File a 2016 calendar year income tax return (Form 1065) and pay any tax due. Provide each partner with a copy of Schedule K-1 (Form 1065).

APRIL 2017

April 10
Employees who work for tips - if you received $20 or more in tips during March, report them to your employer. You can use Form 4070.

April 18
Besides being the last day to file (or extend) your 2016 personal return and pay any tax due, 2017 first quarter estimated tax payments for individuals, trusts, and calendar-year corporations are due on this date. SEP and Keogh contributions are also due if your return is not being extended.

Corporations – File a 2016 calendar year income tax return (Form 1120) and pay any tax due. If you want an automatic 5-month extension of time to file the return, file Form 7004, Application for Automatic Extension of Time to File Certain Business Income Tax, Information, and Other Returns, and deposit what you estimate you owe.

Other helpful on-line services

www.IRS.gov
www.MyFlorida.com
&
www.Volusia.org