Cost Segregation and the Final Regulations

Clarification for Calculating Asset Dispositions

By Mark Vorkapich

For taxable years beginning on or after January 1, 2014, there is a small window of time during which taxpayers can "scrub" their fixed asset system for existing partial asset dispositions. These are duplicate assets, which are currently being depreciated simultaneously, in which the initial entries can now be written off. These assets are generally components of larger assets (i.e., roof on a building, engine on a truck). This provides an immediate deduction and cleans up the fixed asset record.

With the finalization of IRC section 263(a), a framework is now established for how the depreciation records of a building should be structured for fixed asset depreciation purposes. Combined with an understanding of IRC section 168 dispositions, these are the two components needed to properly set up and maintain real property depreciation records for both capital expenses and deductions with regard to federal taxation.

The Final Regulations

On September 13, 2013, the Treasury Department published final regulations (TD 9636) that affect all taxpayers who acquire, produce, or improve tangible property by expanding and clarifying the rules surrounding capital expenditures under IRC section 263(a) (with exceptions for certain small taxpayers). These regulations took effect on January 1, 2014.

The final regulations refined the definition of "unit of property" and established a fact-based approach to determining whether work performed on a building or leasehold improvements should be considered a deductible repair or a capital expense. In addition, it allowed the routine maintenance safe harbor to now apply to buildings. (The final regulations use 10 years as the period of time in which a taxpayer must reasonably expect to perform the relevant activities more than once.)

Since then, the Treasury Department has also issued final regulations on the disposition of Modified Accelerated Cost

Recovery System (MACRS) property. (See IRC section 1.168; August 14, 2014.) They represented the last major component of the IRS's long-running effort to provide updated regulatory guidance on the capitalization, depreciation, and disposition of tangible personal property. The disposition regulations provide rules for determining gain or loss upon the disposition of depreciable property, determining the asset disposed of, and accounting for partial dispositions. They apply to tax years beginning on or after January 1, 2014.

An engineering-based cost segregation study traditionally has been used to reclassify federal tax depreciation rates of real property, from a one lump-sum asset listed in a fixed asset system as a "building" with a recovery period of 39 years, to multiple detailed entries that identify separate assets with shorter recovery periods lasting for five, seven, or 15 years. Under the final regulations, however, a building and its structural components are considered a single unit of property. The qualitative and quantitative information already contained in an engineering-based study can now be used to readily identify all of these assets. Examples of this are reflected in asset breakouts that show a specific quantity of each particular asset (e.g., the number of rooftop units, windows, electrical connections).

The "unit of property" for buildings now consists of the building structure and building systems, which include the following:

- Heating, ventilation, and air conditioning (HVAC) systems
- Plumbing systems
- Electrical systems
- All escalators
- All elevators
- Fire protection and alarm systems
- Security systems

■ Gas distribution systems
■ Other structural components identified in published guidance.

What Is Considered a Capital Improvement?

The final regulations define a capital improvement as any expenditure that results in a betterment, restoration, or adaptation.

■ A betterment to a unit of property corrects a material condition or defect that existed prior to the taxpayer's acquisition; results in a material addition; or results in a material increase in capacity, productivity, efficiency, strength, quality, or output.
■ Restoration is the replacement of a major component or substantial structural part of a unit of property, in order to return the property to its ordinary efficient operating condition, if the property has deteriorated to a state of disrepair, or in order to rebuild the property to a like-new condition after the end of its class life.
■ Adaptation means adapting the property to a new or different use if the adaptation is not consistent with the taxpayer's intended ordinary use of the property at the time the property was originally placed in service by the taxpayer.

There is no one factor that determines whether an expenditure results in an improvement. A taxpayer must consider all of the facts and circumstances; these factors are both quantitative and qualitative. The following are examples of quantitative analysis that would not result in an improvement:

■ The replacement of 2 of 10 HVAC units (20%)
■ The replacement of 3 of 20 plumbing fixtures (15%)
■ The replacement of 30 of 300 windows (10%).

This has raised an interesting point of discussion: Could the given examples be extrapolated to the building system as a whole? An example of this would be whether expenditures not exceeding 20% of the costs of the HVAC can be expensed.

In addition to the quantitative analysis above, the final regulations also consider the qualitative factors of expenditure. For example, the replacement of a roof membrane is not a betterment, but the replacement of one HVAC unit that increased energy efficiency by 50% would need to be capitalized.

Final IRC Section 168 Regulations Detail Rules for Dispositions

The final regulations made two clarifications of the 2013 proposed rules: 1) how to determine the unadjusted depreciable basis of a disposed asset in a general or multiple asset account or a disposed portion of an asset, and 2) how to make certain elections on the disposition of assets included in a general asset account when the demolition of structures (IRC section 280B) applies.

The basis of an asset in a general asset account, or an asset that is partly disposed of, can be determined using any reasonable method. The final regulations do not include discounting the cost of the replacement asset by the Consumer Price Index (CPI) as an example of a reasonable method. Instead, the Producer Price Index (PPI) for "finished goods/final demand" may be used. These indices more accurately reflect inflation for capital expenditures. The final regulations also provide that discounting the cost of the replacement asset using the PPI for finished goods is a reasonable method only if the replacement asset is considered a restoration [Treasury Regulations section 1.263(a)-3(k)] and not a betterment [Treasury Regulations section 1.263(a)-3(j)] or an adaptation to a new or a different use [Treasury Regulations section 1.263(a)-3(l)].

The final regulations provide that a taxpayer may use any reasonable method for determining the basis of the disposed portion of an asset, only if it is impractical to make the determination from the taxpayer's records. If the asset, a portion of which is disposed of, is in a multiple-asset account, the reasonable method used by the taxpayer must be consistently applied to all assets and portions of assets in the same multiple accounts.

The stumbling block for most taxpayers lies in correctly trying to identify a reasonable method and implementing that method. By incorporating the estimating techniques utilized in cost segregation studies, specific detailed estimates can be made based on each of the applicable assets. It is the correct identification of those assets that can then allow taxpayers to properly calculate their dispositions of real property. ❑

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