May, 2015

Cost-Segregation Studies and the Impact of the Tangible Property Regulations

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With the recovering economy and the tangible property regulations (T.D. 9689 and T.D. 9636, the "final regulations") on so many businesses' minds, many taxpayers are taking advantage of cost-segregation studies for their building properties. Cost-segregation studies have long provided benefits to taxpayers by segregating shorter-lived personal property (e.g., carpet or other personal property) from longer-lived real property.

In addition to generally providing results favourable to taxpayers by accelerating depreciation deductions on the segregated property (including identifying property that may be eligible for bonus depreciation), these studies can help to break out the cost of components of building property, which can assist taxpayers in determining the remaining basis of disposed portions of building assets. Although these studies are nothing new, certain rules in the final regulations, when compared to the previous regulations, as well as certain nuances of the transition guidance issued to assist taxpayers in adopting the regulations, may have a surprising effect on how cost-segregation studies are conducted.

This newsletter highlights several important aspects of the final regulations and related transition guidance that may affect cost-segregation studies and resulting changes in accounting methods. Readers should be aware that this item is intended to provide only a high-level discussion of certain aspects of federal income tax law as the law applies to cost-segregation studies. This item also focuses solely on assets excluded from general asset accounts because assets included in general asset accounts may be subject to different rules for dispositions (see Regs. Sec. 1.168(i)-1 for rules that apply to general asset accounts).

Potential Impact 1: Partial Dispositions and Remaining Adjusted Basis

As with the law before the final regulations were issued, if a taxpayer disposes of an asset (e.g., through abandonment), the taxpayer must recognize the disposition for federal income tax purposes in the year the disposition occurs. Thus, asset dispositions generally result in taxpayers' being unable to continue to depreciate the remaining basis of the disposed asset after the disposition occurs.

The final regulations permit an election to recognize partial dispositions of assets. In this case, taxpayers may elect to recognize abandonments of portions of assets (e.g., structural components of a building) (Regs. Sec. 1.168(i)-8(d)(2)). If a taxpayer makes the election, in the case of a physical abandonment, the taxpayer recognizes a loss in the amount of the adjusted depreciable basis of the portion of the asset at the time of abandonment (Regs. Sec. 1.168(i)-8(e)(2)). Thus, a partial-disposition election can be very favorable to taxpayers. However, taxpayers that elect to recognize a partial disposition will have to capitalize the expenditure for the replacement portion even if the expenditure would normally be a deductible repair.

While the partial-disposition election generally provides a benefit to taxpayers undergoing improvements, the mechanism to determine the adjusted basis of the removed component can be complex. Most taxpayers do not break out the acquisition cost of each component of a building on their fixed-asset schedules. If practicable, a taxpayer must use its records to determine the removed component's unadjusted depreciable basis (which is then used to determine the adjusted depreciable basis).

If it is impracticable to use the taxpayer's records, however, the regulations provide that a taxpayer may use any reasonable method to make that determination (Regs. Sec. 1.168(i)-8(f) (3)(i)). Reasonable methods include, but are not limited to, discounting the cost of the replacement portion of the asset to its placed-in-service-year cost using the producer price index for finished goods, a pro rata allocation of the unadjusted depreciable basis of the asset based on the replacement cost of the disposed portion of the asset and the replacement cost of the asset, or a study allocating the cost of the asset to its individual components (Regs. Sec. 1.168(i)-8(f)(3)(i)). Once a taxpayer uses a method to determine the removed portion's unadjusted depreciable basis, the same method must be consistently applied to all portions of that same asset.

Cost-segregation studies can assist taxpayers in determining any remaining basis allocable to the disposition of partial assets. However, this determination may apply to partial dispositions that have already occurred (or are occurring in the current tax year).

Thus, if the taxpayer is undertaking a cost-segregation study to make a partial-disposition election, the taxpayer's use of the cost-segregation study's results will establish a method of accounting that will apply to any future determinations of remaining basis for partial dispositions on that same asset. This may mean that cost-segregation reports will need to include detailed information about how the specialist made any basis determinations that could affect future partial dispositions.

Potential Impact 2: Treatment of Removal Costs and Building Demolitions

As with the regulations requiring recognition of dispositions of whole assets, rules regarding the treatment of removal costs related to dispositions of whole assets are the same under the final regulations as they were under the previous regulations. Under Rev. Rul. 2000-7, if a taxpayer disposes of a depreciable asset, the removal costs incurred are generally included in the disposed asset's basis. The final regulations governing the treatment of improvement costs not only retain this rule, but they also favorably expand it by providing that removal costs incurred in a partial disposition of an asset are deductible as long as the taxpayer recognizes the partial disposition for federal income tax purposes (Regs. Sec. 1.263(a)-3(g)(2)(i)). While removal costs (and partial dispositions) are favorably treated in cases where the disposition is recognized, Sec. 280B does have a potentially negative impact on removal costs and partial dispositions of building assets. Under Sec. 280B, if a building is demolished, any amounts expended for the demolition (e.g., removal costs), as well as any loss sustained on account of the demolition (e.g., the remaining adjusted basis of the building), must be capitalized to the land and may not be deducted.

While Sec. 280B is nothing new, issuance of the final regulations raised questions regarding the coordination of the regulations with Sec. 280B and its continued applicability in light of specific rules now allowing for the deduction of removal costs and partial dispositions of assets. However, Sec. 280B is still very much alive and will serve to trump the rules and provisions under Regs. Secs. 1.263(a)-3 and 1.168(i)-8 (see Regs. Secs. 1.263(a)-3(g)(2)(i) and 1.168(i)-8(e)). Thus, a taxpayer intending to demolish one or more of its buildings will likely not be able to recognize a deduction for removal costs or a loss for the remaining adjusted basis of the building.

Cost-segregation studies are not only beneficial in breaking out personal assets from real property, but they can also determine the adjusted basis of components removed during renovations or remodels. Assuming a renovation or remodel results in a capitalizable improvement under Regs. Sec. 1.263(a)-3, a taxpayer should consider electing to recognize any partial dispositions

resulting from the activity. In this case, the taxpayer can generally deduct any associated removal costs as well. However, a taxpayer should be cautious of the impact of Sec. 280B on demolitions of building property. In this case, any removal costs and/or losses sustained as a result of the demolition must be capitalized to the underlying land and may not be recognized currently. Thus, taxpayers undertaking cost-segregation studies should work with their cost-segregation specialists to ensure that dispositions (and related removal costs) are being evaluated and to determine the effect, if any, of Sec. 280B.

Potential Impact 3: Depreciation and Disposition Method Changes and Associated Scope Limitations

Many taxpayers undertaking cost-segregation studies as part of complying with the final regulations will file one or more Forms 3115. Changes in accounting methods related to dispositions may include recognizing a prior-year disposition of a whole asset or making a late partial-disposition election to recognize a prior-year disposition. (The ability to make a late partial-disposition election is available for years beginning before 2015.) Rev. Procs. 2015-13 and 2015-14 provide automatic consent procedures to change one or more methods of accounting to comply with the disposition rules under Regs. Sec. 1.168(i)-8.

Generally, certain scope limitations apply to taxpayers filing automatic (and, in certain cases, advance) consent Forms 3115. For example, these limitations generally exclude taxpayers that have made a change in accounting method for the same item in the past five years and taxpayers in the final year of a trade or business (see Sections 5.01(1)(d) and (f) of Rev. Proc. 2015-13). If a limitation applies, the taxpayer may not file the Form 3115 unless the taxpayer qualifies for an exception (see Section 5 of Rev. Proc. 2015-13). However, Rev. Proc. 2015-14 waives these scope limitations for changes made to adopt the final disposition regulations as
long as the changes are made for years beginning before 2015 (see, e.g., Section 6.38(2) of Rev. Proc. 2015-14). Thus, taxpayers that would otherwise be excluded from filing automatic method changes may nonetheless file the required Forms 3115 to ensure compliance with the
regulations for their first tax year beginning in 2014.

Thus, in addition to one or more disposition method changes, most taxpayers undergoing cost segregation studies will also require a method change for the depreciation of one or more assets. Rev. Proc. 2015-14 provides for a waiver of the scope limitations for this change in limited circumstances. Specifically, each disposition method change under Rev. Proc. 2015-14 provides that if a taxpayer makes both that change and a change for depreciation under Section 6.01 of Rev. Proc. 2015-14 on a single Form 3115

for the same asset for the same year of change, the scope limitations of Rev. Proc. 2015-13, Sections 5.01(d) and (f) (relating to the final year of a taxpayer's trade or business and a prior change for the same item made within the past five years, respectively) do not apply to the taxpayer for either change (see, e.g., Section 6.33(4)(b) of Rev. Proc. 2015-14).

While potentially beneficial, this waiver applies only in the case of concurrent depreciation and disposition changes made for the same asset. In the case of a traditional cost-segregation study that serves to segregate personal property from real property, this waiver may not apply since the depreciation change being made to treat the personal property assets as depreciable over five, seven, or 15 years, as applicable, is not being made for the building asset to which the disposition change applies.

While the expansion of the scope-limitation waiver to certain depreciation method changes may prove beneficial to some taxpayers, traditional depreciation method changes resulting from cost-segregation studies may still fall outside of this limited wavier. Thus, to ensure valid method changes are filed, it is critical for taxpayers to understand the interaction between the automatic method change procedures to comply with the disposition regulations and other accounting method changes for depreciation (as well as related scope limitations and waivers).

Conclusion

Cost-segregation studies have for many years provided significant benefits to taxpayers by identifying assets that may be subject to accelerated (and bonus) depreciation. The use of studies is more important than ever because they can help ensure that taxpayers are complying with and benefiting as fully as possible from the final repair regulations. A cost segregation study can assist with the use of consistent, reasonable methods to determine the basis of disposed assets and partial dispositions, as well as the treatment of removal costs (including the applicability of Sec. 280B in the case of demolitions).