# Update Info

<table>
<thead>
<tr>
<th>Chapter</th>
<th>Page No.</th>
<th>Source</th>
<th>Update</th>
</tr>
</thead>
<tbody>
<tr>
<td>22</td>
<td>464</td>
<td>Chart</td>
<td>Updated PPI information Charts to aid in calculating partial asset dispositions.</td>
</tr>
<tr>
<td>22</td>
<td>466</td>
<td>TC Summ. OP. 2017-31</td>
<td>IRS disallowed depreciation based on land.</td>
</tr>
<tr>
<td>22</td>
<td>469</td>
<td>CCA 201614037</td>
<td>Taxpayer making changes in accounting method to reflect 2013 tangible property regulations has audit protection from IRS auditors making a prior year change.</td>
</tr>
<tr>
<td>22</td>
<td>443</td>
<td>IRS</td>
<td>IRS's Large Business and International Tax Division issues 195 MSSP titled&quot; Capitalization of Tangible Property&quot;.</td>
</tr>
</tbody>
</table>
## Update Info

<table>
<thead>
<tr>
<th>Chapter</th>
<th>Page No.</th>
<th>Source</th>
<th>Update</th>
</tr>
</thead>
<tbody>
<tr>
<td>22</td>
<td>472</td>
<td>AOD 2017-02</td>
<td>IRS does not acquiesce to a court decision of when property was first placed in service.</td>
</tr>
<tr>
<td>22</td>
<td>472</td>
<td>NEW CASE</td>
<td>Stine, LLC v. USA, 115 AFTR 2d 2015-637 (DC LA), 01/27/2015- buildings were substantially complete, fully functional. Placed in service does not require the business to be &quot;open for business&quot;.</td>
</tr>
<tr>
<td>22</td>
<td>440/448</td>
<td>PATH</td>
<td><em>De minimis</em> safe harbor for taxpayers without an AFS raised to $2,500.</td>
</tr>
<tr>
<td>22</td>
<td>440/486</td>
<td>PATH</td>
<td>Bonus depreciation for automobiles restored through 12/31/19 with phase outs starting after 12/31/17.</td>
</tr>
<tr>
<td>22</td>
<td>440</td>
<td>PATH</td>
<td>Restoration of the ability of a corporation to trade bonus and accelerated depreciation for refund of otherwise deferred AMT credits.</td>
</tr>
<tr>
<td>22</td>
<td>440/478</td>
<td>PATH</td>
<td>15 year qualified restaurant and improvement property retroactively restored and made permanent.</td>
</tr>
<tr>
<td>22</td>
<td>440</td>
<td>PATH</td>
<td>Race horse 3 year MACRS treatment restored and extended.</td>
</tr>
</tbody>
</table>
## Update Info

<table>
<thead>
<tr>
<th>Chapter</th>
<th>Page No.</th>
<th>Source</th>
<th>Update</th>
</tr>
</thead>
<tbody>
<tr>
<td>22</td>
<td>440</td>
<td>PATH</td>
<td>Restored and permanently extended higher IRC 179 limits. Limits to be adjusted by inflation.</td>
</tr>
<tr>
<td>22</td>
<td>440</td>
<td>PATH</td>
<td>Computer Software IRC 179 eligibility restored and made permanent.</td>
</tr>
<tr>
<td>22</td>
<td>440</td>
<td>PATH</td>
<td>Expensing of qualified real property is made permanent without a carryover limitation.</td>
</tr>
<tr>
<td>22</td>
<td>440</td>
<td>PATH</td>
<td>Beginning in 2016- Introduces &quot;qualified improvement property&quot;.</td>
</tr>
<tr>
<td>22</td>
<td>440</td>
<td>PATH</td>
<td>Removes restrictions on air conditioners and heating units from Code. Sec. 179</td>
</tr>
<tr>
<td>22</td>
<td>469</td>
<td>Rev. Proc 2015-13</td>
<td>New increased <em>de minimis</em> election for positive changes that are less than $50,000.</td>
</tr>
</tbody>
</table>
I. What’s New


B. IRS Notice 2017-6 allows taxpayers to elect automatically the final tangible property regs. without asking for an accounting change. Applies to tax year 2016, changes prior to can be made up until 12/20/2017

HELP ON IRS WEBSITE: The IRS has added Tangible Property Regulations—Frequently Asked Questions (FAQs) to their website at www.irs.gov/businesses/small-businesses-self-employed/tangible-property-final-regulations. It includes FAQs regarding the *de minimis* safe-harbor election and other elections and procedures.
I. What’s New

The predicted headaches and problems with complying the regulations are a fact. But as many predicted many of the rough edges are slowing disappearing with IRS trying to make things easier on smaller taxpayers.

Repair or Improve?
II. Misc. Summary of Path Act
Depreciation Changes

<table>
<thead>
<tr>
<th>PATH</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>PATH</strong></td>
<td><em>De minimis</em> safe harbor for taxpayers without an AFS raised to $2,500.</td>
</tr>
<tr>
<td><strong>PATH</strong></td>
<td>Restoration of Bonus depreciation through 12/31/2019 with phase outs starting after 12/31/2017.</td>
</tr>
<tr>
<td><strong>PATH</strong></td>
<td>Bonus depreciation for automobiles restored through 12/31/19 with phase outs starting after 12/31/17.</td>
</tr>
<tr>
<td><strong>PATH</strong></td>
<td>Restoration of the ability of a corporation to trade bonus and accelerated depreciation for refund of otherwise deferred AMT credits.</td>
</tr>
<tr>
<td><strong>PATH</strong></td>
<td>15 year qualified restaurant and improvement property retroactively restored and made permanent.</td>
</tr>
<tr>
<td><strong>PATH</strong></td>
<td>Race horse 3 year MACRS treatment restored and extended.</td>
</tr>
<tr>
<td><strong>PATH</strong></td>
<td>Restored and permanently extended higher IRC 179 limits. Limits to be adjusted by inflation.</td>
</tr>
<tr>
<td><strong>PATH</strong></td>
<td>Computer Software IRC 179 eligibility restored and made permanent.</td>
</tr>
<tr>
<td><strong>PATH</strong></td>
<td>Expensing of qualified real property is made permanent without a carryover limitation.</td>
</tr>
<tr>
<td><strong>PATH</strong></td>
<td>Beginning in 2016—Introduces &quot;qualified improvement property&quot;.</td>
</tr>
<tr>
<td><strong>PATH</strong></td>
<td>Removes restrictions on air conditioners and heating units from Code. Sec. 179.</td>
</tr>
</tbody>
</table>
III. Deduction versus Capitalization and the New Final Regulations

What do we have – a mismatched series of:

- Court Cases
- Standards or Lack of Standards in the regulations.
- IRS guidance that is mostly weak.

The IRS has tried but for most not a lot has changed, wait for the challenge to come.
III. Unit of Property (UOP) Rules for Capitalization Purposes

B. We had a series of court cases in the early 2000s trying to establish what a UOP is:
   1. FedEx Corp – Aircraft not the Engine
   2. Smith – The tooling not the entire manufacturing Line
   3. Ingram – The towboat not the engine

Regulations attempted to provide guidance
III. Unit of Property (UOP) Rules for Capitalization Purposes

By the definitive standard

E. A UOP is based on a functional interdependence standard – Reg. 1.263(a)

Components of property are functionally interdependent if placing in service of one component by a taxpayer is dependent on placing in service of another component by the taxpayer.

The standard can be convoluted and difficult to understand.
III. Unit of Property (UOP) Rules for Capitalization Purposes

How can I use a printer without the computer, i.e. I can use the computer without a printer, so not a UOP

**EXAMPLE:** Jerome provides legal services. Jerome purchased a laptop computer and a printer to use in providing legal services. The computer and printer are property other than a building, so the initial UOPs are determined under the general rule. The computer and printer are separate UOPs because they are not functionally interdependent (i.e., the placing in service of the computer is not dependent on the placing in service of the printer). [Reg. §1.263(a)-3(e)(6), Example 9]
III. Unit of Property (UOP) Rules for Capitalization Purposes

When property components require a relationship with other components to function they are considered to be a single UOP.

**EXAMPLE:** Deliver Co. owns trucks used in its shipping business. Each truck consists of various components, such as an engine, wheels, batteries, transmission, etc. Deliver acquired a truck with all these components. Deliver’s truck is property other than a building, so the initial UOP is determined under the general rule. The truck is a single UOP because it consists entirely of components that are functionally interdependent. [Reg. §1.263(a)-3(e)(6), Example 8]

But may want to separate, i.e. tires different depreciable life, Page 475
III. Unit of Property (UOP) Rules for Capitalization Purposes

I am from the IRS and I am here to help you but:

- It only took them 195 pages
- FYI it is actually the ATG (Audit Technique Guide)

NEW: The IRS’s Large Business and International Tax Division issued a 195-page MSSP on 9/14/16 titled “Capitalization of Tangible Property.” The guide can be found as part of the Gear Up Business Entity tool box under the title tangiblepropertyatg9142016.pdf.
IV. Requirement to Capitalize Amounts Paid for Improvements (BAR Tests)

When the taxpayer pays an amount for the improvement of the UOP they must be capitalized if they are a:

(B) Betterment
(A) Adaption
(R) Restoration

When and if the expenditures for existing assets are not one of the above they will be a generally deductible repair.
V. Betterments

To be a Betterment the Expenditure will:

1. Ameliorates (to make or become better, more bearable, or more satisfactory, improve) a material condition or defect.
2. Results in a material addition.
3. Results in a material increase in capacity.
V. Betterments

EXAMPLE: A taxpayer acquires land with a leaking underground storage tank left by the previous owner. Costs to clean up the land would be an improvement because they fix a material condition or defect that arose prior to the acquisition. [Reg. §1.263(a)-3(j)(3), Example 1]

EXAMPLE: A taxpayer adds a stairway and loft to its retail building to increase its selling space. Costs to build the stairway and loft are for an improvement because they materially increase the capacity of taxpayers' building structure. [Reg. §1.263(a)-3(j)(3), Example 19]

EXAMPLE: A taxpayer adds expansion bolts to its building located in an earthquake prone area. These bolts anchor the building frame to its foundation, providing additional structural support and resistance to seismic forces. Costs to add these expansion bolts would be an improvement because they increase the strength of the building structure. [Reg. §1.263(a)-3(j)(3), Example 11]
V. Betterments

EXAMPLE: A taxpayer owns a building he uses for his retail business. Over time, the waterproof membrane (top layer) on the roof begins to wear, and the retailer begins experiencing water seepage and leaks throughout its premises. To eliminate the problem, a contractor recommends a new rubber membrane be put over the worn membrane. The new membrane is comparable to the worn membrane when it was originally placed in service.

To determine whether the amount is for a betterment, the condition of the building structure after the expenditure must be compared to the condition of the structure when the building was placed into service, because no previous correction to the effects of normal wear and tear has been made. Under these facts, the amount paid to add the new membrane to the roof is not for a material addition or a material increase in the capacity of the building structure as compared to the condition of the structure when it was placed into service. Moreover, the new membrane is not reasonably expected to materially increase the productivity, efficiency, strength, quality, or output of the building structure as compared to the condition of the building structure when it was placed in service. Therefore, the taxpayer is not required to treat the amount paid to add the new membrane as a betterment to the building and may deduct the expense as a repair. [Reg. §1.263(a)-3(j)(3), Ex. 13]
VI. Restorations

A restoration must be capitalized, to be restoration the UOP would:

✓ Returns a UOP to a state of usefulness after it had fallen into a general state of disrepair.

✓ It would be a rebuilding of the UOP to like-new-condition.

✓ A replacement of a part or combination of parts that is a major component of the UOP.
VI. Restorations

What to do with the old semi abandoned UOP

**EXAMPLE:** Diron owns and operates a farm with several barns and outbuildings. Diron did not use or maintain one of the outbuildings on a regular basis, and the outbuilding fell into a state of disrepair. The outbuilding previously was used for storage but can no longer be used for that purpose, because the building is not structurally sound. Diron decides to restore the outbuilding and pays an amount to shore up the walls and replace the siding. An amount is paid to improve a building if the amount is paid to restore the building structure or any building system. The walls and siding are part of the building structure. Diron must treat the amount paid to shore up the walls and replace the siding as a restoration of the building structure because the amounts return the building structure to its ordinarily efficient operating condition after it had deteriorated to a state of disrepair and was no longer functional for its intended use. Therefore, Diron must treat the amount paid to shore up the walls and replace the siding as an improvement to the building UOP and must capitalize the amount paid.
VII. Adaptation – Adapt Property to a New or Different Use

EXAMPLE: Adaptation to a New or Different Use

A taxpayer owns a manufacturing building that it used to manufacture items for several years beginning when the building was placed in service by the taxpayer. The taxpayer pays amounts to convert the manufacturing building into a showroom through modifications to the building structure and various building systems. Costs to convert the manufacturing building into a showroom are improvements because the structure and systems are converted to a new or different use that is inconsistent with the intended ordinary use of the building (manufacturing items) at the time it was placed in service. [Reg. 1.263(a)-3(I)(3), Example 1]

Adaptation
VII. Adaptation – Adapt Property to a New or Different Use

EXAMPLE: Not a New or Different Use

A taxpayer owns a building that he plans to sell. In order to prepare the property for viewing, the taxpayer paints the walls and refinishes the floors. Preparing the property for sale by painting walls and refinishes floors is not adapting the building to a new or different use for purposes of determining whether there is an improvement to the property. [Reg. 1.263(a)-3(l)(3), Example 3]

An extension of the property’s current use but still may need capitalization
VIII. De Minimis Safe-Harbor Election

There is available to the taxpayer an **annual election** to apply an exception to the general capitalization rule, **WHEN AND ONLY WHEN** the taxpayer has in place a **minimum capitalization policy**.
VIII. De Minimis Safe-Harbor Election

B. The election is applied at the UOP level, therefore an invoice with multiple UOPs apply the rule to each item (UOP).

There are some anti-abuse rules (attempts to prevent taxpayer from dividing UOPs into pieces) and certain items are excluded.

The election will not apply to rotable and spare parts that have been elected to be capitalized or use the optional method of accounting.
VIII. De Minimis Safe-Harbor Election

G. The **annual** election is available to ALL taxpayers but has certain limitations for taxpayers based on standards of what the regulations label “applicable financial statements (AFS).

Taxpayers who have an eligible AFS are:

- Those who file with the SEC.
- Those who have audited financials with a report letter.
- Those who provide a financial statement (not a tax return) to ANY federal or governmental agency other than the SEC or IRS.
VIII. De Minimis Safe-Harbor Election

H. If the taxpayer has an AFS and if:

1. Had written accounting procedures at beginning of year defining a threshold for property expensing for non-tax purposes.

2. Those items were treated as an expense on those financial statements.

3. The amount for the property does not exceed (safe harbor threshold) $5,000 per UOP.

WARNING: A taxpayer who has NO accounting procedures is NOT allowed to use the *de minimis* rule!
VIII. De Minimis Safe-Harbor Election

I. If the taxpayer does not have an AFS and if:

1. Had written accounting procedures at beginning of year defining a threshold for property expensing for non-tax purposes.
   - Those items were treated as an expense on those financial statements.
   - The amount for the property does not exceed (safe harbor threshold) $2,500 per UOP.

WARNING: A taxpayer who has NO accounting procedures is NOT allowed to use the de minimis rule!
VIII. De Minimis Safe-Harbor Election

Some additional issues:

J. If the taxpayer has a written policy of some other amount greater or less than $5,000/$2,500 they must adhere to that policy. If the amount is greater than the safe-harbor amounts the taxpayer may use but will be required to demonstrate the amounts “clearly reflect income”.
IX. Safe Harbor for Small Taxpayers

Small taxpayers, those who averaged less than $10 million in gross receipts in the past three years:

Applies to each UOP

- 2% of unadjusted basis of property

- $10,000 or less for property with an unadjusted basis of $1,000,000 or less.
IX. Safe Harbor for Small Taxpayers

D. How to make the election:

1. Attach statement in required format to timely filed return.
2. Title statement Section 1.26(a)-3(h) Safe Harbor Election for Small Taxpayers
3. This election is not made by filing Form 3115 but by the indicated statement and may not be revoked once elected by the taxpayer made each year with the original return.
IX. Safe Harbor for Small Taxpayers

When the taxpayer exceeds the safe harbor amounts then the Small Taxpayer election will not be allowed.

EXAMPLE: Anchor, Inc., a qualifying small taxpayer, owns a building that it uses in its business. In Year 1, Anchor’s building has an unadjusted basis of $750,000. In Year 1, Anchor pays $5,500 for repairs, maintenance, improvements and similar activities to the office building. Because Anchor’s building UOP has an unadjusted basis of $1,000,000 or less, Anchor’s building constitutes eligible building property. The aggregate amount paid by Anchor during Year 1 for repairs, maintenance, improvements and similar activities on this eligible building property does not exceed the lesser of $15,000 (2% of the building’s unadjusted basis of $750,000) or $10,000. Therefore, Anchor may elect to not apply the capitalization rule to the amounts paid for repair, maintenance, improvements, or similar activities on the office building in Year 1. If Anchor properly makes the election for the office building and the amounts otherwise constitute deductible ordinary and necessary expenses incurred in carrying on a trade or business, then Anchor may deduct these amounts. [Reg. §1.263(a)-3(h)(10), Example 1]
IX. Safe Harbor for Small Taxpayers

Failure is not an option, if the taxpayer exceeds either threshold there will be NO AVAILABLE ELECTION for that UOP.

EXAMPLE: Safe Harbor Inapplicable

Assume the same facts except Anchor pays $10,500 for repairs, maintenance, and improvements in Year 1. Because the amount exceeded $10,000 (the lesser of the two limits) the safe harbor cannot be used. Anchor must apply the general improvement rules to determine which amounts must be capitalized. [Reg. 1.263(a)-3(h)(10), Example 2]
X. Routine Maintenance Safe Harbors

Definition – Work performed on a unit of property that does not “improve” the UOP, i.e. “significantly” extending the useful life of the UOP, but dealing with issues of normal wear and tear of the asset.
X. Routine Maintenance Safe Harbors

B. To be routine maintenance of a building the expenditure must:

1. Replacing damaged or worn parts with comparable and commercially available replacement parts.

2. The work is routine only if the taxpayer anticipates performing the work more than once during a ten year period.
X. Routine Maintenance Safe Harbors

B. To be routine maintenance of a building the expenditure must:

3. Expectation was reasonable that the work would be performed at least twice during the period.

4. Determination is based on what is normal and customary in the industry for that type of property.
X. Routine Maintenance Safe Harbors

**EXAMPLE:** In Year 1, GGI acquires a large retail mall in which it leases space to retailers. The mall contains an escalator system with 40 escalators, which includes landing platforms, trusses, tracks, steps, handrails, and safety brushes. In Year 1, when GGI placed its building into service, GGI reasonably expected that it would need to replace the handrails on the escalators approximately every four years to keep the escalator system in its ordinarily efficient operating condition. After a routine inspection and test of the escalator system in Year 4, GGI determines that the handrails need to be replaced and pays an amount to replace the handrails with comparable and commercially available handrails. Because the replacement of the handrails involves recurring activities that GGI expects to perform as a result of its use of the escalator system to keep the escalator system in an ordinarily efficient operating condition, and it reasonably expects to perform these activities more than once during the 10-year period beginning at the time the building system was placed in service, the amounts paid by GGI for the handrail replacements are within the routine maintenance safe harbor. Accordingly, the amounts paid for the replacement of the handrails in Year 4 are deemed not to improve the UOP and are not required to be capitalized [Reg. 263(a)-3(i)(6), Example 13].
X. Routine Maintenance Safe Harbors

Equipment Considerations
Different industries different results perhaps.
Do not confuse the Class life with the MACRS life

Table B-2. Table of Class Lives and Recovery Periods

<table>
<thead>
<tr>
<th>Asset class</th>
<th>Description of assets included</th>
<th>Recovery Periods (in years)</th>
</tr>
</thead>
<tbody>
<tr>
<td>01.1</td>
<td>Agriculture: Includes machinery and equipment, grain bins, and fences but no other land improvements, that are used in the production of crops or plants, vines, and trees; livestock; the operation of farm dairies, nurseries, greenhouses, sod farms, mushroom cellars, cranberry bogs, apiaries, and fur farms; the performance of agriculture, animal husbandry, and horticultural services.</td>
<td>Class Life (in years)</td>
</tr>
<tr>
<td>01.11</td>
<td>Cotton Ginning Assets</td>
<td>10</td>
</tr>
<tr>
<td>01.21</td>
<td>Cattle, Breeding or Dairy</td>
<td>7</td>
</tr>
<tr>
<td>15.0</td>
<td>Construction: Includes assets used in construction by general building, special trade, heavy and marine construction contractors, operative and investment builders, real estate subdividers and developers, and others except railroads.</td>
<td>6</td>
</tr>
</tbody>
</table>
X. Routine Maintenance Safe Harbors

Example:

A farmer purchases a tractor they anticipate the replacement of the tires on the tractor every four years, this would be twice during the class life.

A construction company purchases a tractor they anticipate the replacement of the tires on the tractor every four years, this would be once during the class life.
XI. Election to Capitalize Repair and Maintenance Costs

The taxpayer may elect to capitalize repair and maintenance costs to qualify the taxpayer must:

✓ Be in a trade or business
✓ Treat the item as capital on books

How to make the election:

- Attach a statement to a timely filed return
- All maintenance and repair items must be capitalized
- The election will be made annually.
XV. Acquisition or Production of Tangible Property

The costs associated with the acquisition or construction of a UOP must be capitalized:

EXAMPLE: During Year 1, Mallory, Inc. purchases a building for use as an office. Prior to placing the building in service, Mallory incurs costs to repair cement steps, refinish wood floors, patch holes in walls, and paint. During Year 2, Mallory places the building in service and begins using the building as its office. Assume the work Mallory performs does not constitute an improvement to the building or its components. Amounts paid must be capitalized as costs of acquiring the building because the work was performed prior to placing the building in service. [Reg. §1.263(a)-2(d)(2), Ex. 10]

VARIATION: The building is considered placed in service using the mid-month MACRS convention on June 15, Year 2, but was actually placed in service on June 25, Year 2. Mallory, Inc. would have to capitalize any repairs made between June 15th and 25th, because they were incurred prior to the actual placed-in-service date.

Costs incurred to place property in service will be considered costs of acquisition.
XVI. Building & Structural Components

When an improvement is made to any structural component it will be treated as made to the building:

**EXAMPLE:** Bubba Gum Company owns a building it uses in its gum manufacturing business. It contains two elevator banks in different locations. Each elevator bank contains three elevators. Bubba pays an amount for labor and materials for work performed on the elevators. Bubba must treat the building and its structural components as a single UOP. All of the elevators, including their components, comprise a building system. If an amount paid for work on the elevators results in an improvement (i.e. a betterment) to the elevator system, then Bubba must treat these amounts as an improvement to the building. [Reg. §1.263(a)-3(e)(6), Example 2]
VII. Building & Structural Components

Retirements of a structural component can be recognized and written off:

**EXAMPLE:** Bubba replaces part of the roof of the building. Bubba will have to capitalize the replacement. However, at the time of replacement, Bubba will be allowed to recognize a loss on disposition of the part of the roof that was replaced.

**Good News & Bad News:** The difficulty lies in identifying the adjusted basis of the part of the roof that was retired. A taxpayer may use any reasonable method for purpose of determining the unadjusted depreciable basis including discounting the cost of the replacement asset by the Producer Price Index for Finished Goods or its successor, the Producer Price Index for Final Demand or any index designated by IRS. The good news is Bubba is no longer required to simultaneously depreciate amounts paid for both the removed and new property.

The valuation of component taken out of service will be difficult and guidance is limited to date.
XVI. Building & Structural Components

When a proper determination is made that a component of the UOP has a different depreciable period that component becomes it’s own UOP

EXAMPLE: During Year 1, Unabashed, Inc. acquired and placed in service a building and parking lot for use in its retail operations. Unabashed capitalized the cost of the building and the parking lot and began depreciating both as nonresidential real property over 39 years under MACRS. During Year 4, Unabashed completes a cost segregation study and properly determines the parking lot qualifies as 15-year MACRS property. For Year 4, Unabashed changes its method of accounting to use a 15-year recovery period for depreciation of the parking lot. Unabashed must treat the parking lot as a UOP separate from the building beginning in Year 4. [Reg. §1.263(a)-3(e)(6), Example 18]
XVII. MACRS Property Dispositions

While the Partial Asset Disposition was meant to give the taxpayer relief from depreciating a replaced asset and its replacement, implementation is another matter.
XVII. MACRS Property Dispositions

The “partial disposition election” is made by reporting the gain, loss or deduction, no more paperwork for that.

BUT the deduction must be taken on a timely filed original return (extensions are allowed and included).
XVII. MACRS Property Dispositions

Valuation is more difficult as VERY few taxpayers will be able to determine the basis of the partially disposed asset readily from the records of the taxpayer.

Solution – IRS has provided in the regulations that the taxpayer can use any “reasonable” method of estimating that amount.
XVII. MACRS Property Dispositions

H. The examples provided in the regulations are:
   1. Discounting the cost of the replacement.
   2. Pro rata allocation of the unadjusted depreciable basis.
   3. Cost segregation study

Each of these methods present their own set of problems but remember at the end of the day they are ESTIMATES.
XVII. MACRS Property Dispositions

The Calculation – Determining the Cost of the “disposed” elevator by discounting the cost of the replacement.

<table>
<thead>
<tr>
<th>Discounted Cost using Producer Price Index for Final Demand</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of New Elevator</td>
</tr>
<tr>
<td>PPI Rollback</td>
</tr>
<tr>
<td>Estimate Prior Elevator</td>
</tr>
<tr>
<td>Depreciation thru 12/31/2015</td>
</tr>
<tr>
<td>Depreciation for 2016</td>
</tr>
<tr>
<td>Adjusted Basis of Replaced Elevator</td>
</tr>
</tbody>
</table>
### XV. MACRS Property Dispositions

#### Form 4797

**Sales of Business Property**

(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))

- **Attachment**
- **Sequence No.** 27

<table>
<thead>
<tr>
<th>Description of property</th>
<th>Date acquired (mo., day, yr.)</th>
<th>Date sold (mo., day, yr.)</th>
<th>Gross sales price</th>
<th>Depreciation allowed or allowable since acquisition</th>
<th>Cost or other basis, plus improvements and expense of sale</th>
<th>Gain or (loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Abandoned Elevator</td>
<td>07/01/2014</td>
<td>06/30/2017</td>
<td>0</td>
<td>11221</td>
<td>150000</td>
<td>-138779</td>
</tr>
</tbody>
</table>

11 Loss, if any, from line 7
12 Gain, if any, from line 7 or amount from line 8, if applicable
13 Gain, if any, from line 31
14 Net gain or (loss) from Form 4684, lines 31 and 38a
15 Ordinary gain from installment sales from Form 5252, line 25 or 36
16 Ordinary gain or (loss) from like-kind exchanges from Form 8824.
17 Combine lines 10 through 16
18 For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below:

a. If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here. Enter the part of the loss from income-producing property on Schedule A (Form 1040), line 28, and the part of the loss from property used as an employee on Schedule A (Form 1040), line 23. Identify as from "Form 4797, line 18a." See instructions.

b. Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Form 1040, line 14

#### August 22, 2017
XVII. MACRS Property Dispositions

The adjusted depreciable basis of the building and the 2017 building depreciation

<table>
<thead>
<tr>
<th></th>
<th>Cost</th>
<th>Depr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Building</td>
<td>$20,000,000</td>
<td>$1,261,000</td>
</tr>
<tr>
<td>Less: Elevator Disposed</td>
<td>-$150,000</td>
<td>-$9,548</td>
</tr>
<tr>
<td>Building Adjusted</td>
<td>$19,850,000</td>
<td>$1,251,452</td>
</tr>
<tr>
<td>Depreciation for 2017</td>
<td></td>
<td>$508,954</td>
</tr>
</tbody>
</table>
XVII MACRS Property Dispositions

Examples of other “reasonable” valuation methods

- PPI Rollback Method (See Page 480 for PPI table)
- Cost Segregation Studies

[Table]

bls.gov/ppi/
XVI MACRS Property Dispositions

bls.gov/ppi/

22 - Capitalization and Amortization
XVIII. Cost Segregation Studies

How does it work?

EXAMPLE: Main Street Banking, Inc. constructs a new bank building on land they already owned for $2.5 million and places it in service on June 30. His accountant advises him to have a cost segregation study conducted and to depreciate the building accordingly. The study shows that approximately $475,000 of the building’s cost will qualify as 5-year MACRS Section 1245 property. Note the result:

<table>
<thead>
<tr>
<th></th>
<th>No Cost Segregation</th>
<th>With Cost Segregation</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Approx. depreciation in first six years</td>
<td>$ 355,235</td>
<td>$ 741,293</td>
<td>$ 386,058</td>
</tr>
</tbody>
</table>

Result – The study was able to identify $475,000 as five year property, reducing the depreciation period from 39.5 to 5 years.
XVIII. Cost Segregation Studies

The Good:
- Depreciation can be significantly accelerated
- Partial Asset dispositions can be more easily identified

The Bad:
- The cost of the study
- In a 1031 exchange the now 1245 property may be difficult to do a swap.
XVIII. Cost Segregation Studies

Sometimes the court puts more credibility in the assessor’s office than the segregation expert.

NEW CASE: Taxpayers owned rental properties in California and included the cost of both the land and the buildings in calculating their depreciation deduction. The IRS disallowed the depreciation attributable to the land based on appraisal information from the Los Angeles County Office of the Assessor. Although the taxpayers agreed that the depreciation was calculated incorrectly, they challenged the accuracy and credibility of reliance on the Los Angeles County Office of the Assessor’s assessments and put forth two alternative methods of valuation: (1) land sales method and (2) insurance method. The Tax Court disagreed, finding that the Office of the Assessor’s allocations to be more reliable and persuasive. Therefore, the IRS's recalculation of the depreciation based on this information was upheld. [Sharon and Steve Nielsen, TC Summ. Op. 2017-31]
XIX. Change in Accounting Method – Form 3115

The following ARE NOT Changes in Accounting Methods and DO NOT require Form 3115, they are elections.

1. Capitalization of Spare Parts.
2. De Minimis Safe Harbor Election
4. Partial Disposition Election
XIX. Change in Accounting Method – Form 3115

Those items that require Form 3115 although they are MANDATORY and AUTOMATIC:

1. Deduction of incidental materials and supplies.
2. Deduction of non-incidental materials and supplies when consumed, i.e. removed from service.
3. Optional method for spare parts.
4. Deducting non-incidental spare parts when they are disposed of.
XIX. Change in Accounting Method – Form 3115

Those items that require Form 3115 although they are MANDATORY and AUTOMATIC:

5. A Late Partial Disposition Election.
6. Capitalization of Acquisition or Production Costs.
7. Changing of UOPs for apply improvement.
XIX. Change in Accounting Method – Form 3115

Higher threshold for income adjustments

NEW DE MIMIMIS ELECTION: A taxpayer may elect a one-year Section 481(a) adjustment period (year of change) for a positive Section 481(a) adjustment that is less than $50,000. To make this election, the taxpayer must complete the appropriate line on the Form 3115 and take the entire Section 481(a) adjustment into account in the year of change when it implements the change in method of accounting [Rev. Proc. 2015-13]. Negative adjustments must still be taken in the year of the change.

And

Audit Protection

NEW DEVELOPMENT: In CCA 201614037, the IRS has concluded that a taxpayer who made an accounting method change to reflect the 2013 tangible property regulations, and did so via the “limited Section 481(a) adjustment,” is protected from IRS auditors making a prior year change to its accounting for those materials and supplies.
XIX. Change in Accounting Method – Form 3115

IRS has updated the listing of sections and codes necessary to request changes in accounting methods, in Rev. Proc. 2017-30

G. Rev. Proc. 2017-30 is effective for a Form 3115 filed on or after Apr. 19, 2017, for a year of change ending on or after Aug. 31, 2016, that is filed under the automatic change procedures of Rev. Proc. 2015-13, as modified.

WARNING: The IRS issued a revised Form 3115, Application for Change in Accounting Method (Rev. December 2015)], as well as corresponding instructions. The revised form replaces the December 2009 version. After April 19, 2016, the December 2015 form must be used. It is equally important to make sure you are referencing the latest Revenue Procedure.
XXIII. When Depreciation Begins and Ends

General Rule – Depreciation begins when the item is:

- Available for its intended purpose (? In every way)
- Placed in service

Which one wins if different

NEW CASE: The taxpayer is a retail operation that sells home building materials and supplies. Some certificates of occupancy had been obtained for 2 new stores before year end, but not the one that would allow customers to enter the stores. The taxpayer argued that the properties were placed in service because they were ready and available for their intended use. The IRS had determined, because the stores were not open for business, they were not placed in service. The district court ruled in favor of the taxpayer, because the buildings were substantially complete, fully functional, and that placed in service does not require the business be “open for business” for purposes of a depreciation allowance. [Stine, LLC vs. USA, 115 AFTR 2d 2015-637 (DC LA), 01/27/2015].
XXIII. When Depreciation Begins and Ends

General Rule – Depreciation begins when the item is:

IRS in AOD says nope do not agree we will continue to pursue these cases

NEW: Action on Decision (AOD 2017-02, 04/13/2017): The IRS issued an AOD announcing it will not acquiesce to a district court decision that two buildings, which the taxpayer had built to function as retail stores, were considered first placed in service for depreciation purposes when they were ready to "house and secure racks, shelving and merchandise." The IRS stated it will continue to rule a retail store is placed in service for depreciation services when it is actually ready and available for regular operation and income-producing use. The district court had ruled in favor of the taxpayer, because the buildings were substantially complete, fully functional, and that placed in service did not require the business be “open for business” for purposes of a depreciation allowance. [Stine, LLC vs. USA, 115 AFTR 2d 2015-637 (DC LA), 01/27/2015].
XXIV. Bonus Depreciation

The end is coming for IRC Sec 168(k). With the PATH Act congress said this is it.

C. Bonus depreciation is available as follows (IRC Sec. 168(k):

1. Property placed in service through December 31, 2017 50%
2. Property placed in service during 2018 40%
3. Property placed in service during 2019 30%
4. Property placed in service after December 31, 2019 N/A
XXIV. Bonus Depreciation

A new category of property – “Qualified Improvement Property”

NEW LAW: Beginning in 2016, qualified leasehold improvement property is no longer “qualified bonus property.” A new category has been added in its place, “qualified improvement property.” This change treats building improvements as qualified property whether or not the improvements are property subject to a lease and also removes the requirement that the improvement be placed in service more than three years after the date the building was first placed in service.
XXIV. Bonus Depreciation

A new category of property – “Qualified Improvement Property”

Any improvement to an interior portion of a non-residential building placed in service after the initial placed in service date except:

1. Enlargement of the building
2. Elevator or Escalator
3. Internal Structural Framework of the Building
Some issues of caution:

- **Bonus depreciation applies unless the taxpayer “elects out”**
- **Qualified Improvement Property only applies to IRC 168(k)**
- **Qualified Improvement Property is not considered qualified real property such as “qualified leasehold improvements”, “qualified restaurant property” and “qualified retail improvement property”**.
# XXV. IRC Section 179 Deduction

<table>
<thead>
<tr>
<th>Taxable Year Begins In</th>
<th>Applicable Depr. Amount</th>
<th>Applicable Invest. Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>$105,000</td>
<td>$420,000</td>
</tr>
<tr>
<td>2006</td>
<td>$108,000</td>
<td>$430,000</td>
</tr>
<tr>
<td>2007</td>
<td>$125,000</td>
<td>$500,000</td>
</tr>
<tr>
<td>2008 – 2009</td>
<td>$250,000</td>
<td>$800,000</td>
</tr>
<tr>
<td>2010 – 2014</td>
<td>$500,000</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>2015</td>
<td>$500,000</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>2016</td>
<td>$500,000</td>
<td>$2,010,000</td>
</tr>
<tr>
<td>2017</td>
<td>$510,000</td>
<td>$2,030,000</td>
</tr>
</tbody>
</table>
XXVI. IRC Sec. 179 Expensing of Qualified Real Property

Heating Units and Air Conditioning can now be expensed but –

It must be a non-residential building

It must be qualified leasehold property, i.e. the unit must be installed on the inside of the building.

NEW LAW: For years beginning after 12/31/15, the PATH Act removed the language that excluded air conditioners and heating units from being Section 179 property.

An air conditioning or heating unit qualifies as § 179 property if such unit is § 1245 personal property, depreciated under § 168, acquired by purchase for use in the active conduct of the taxpayer’s trade or business, and placed in service by the taxpayer in a taxable year beginning after 2015. For example, portable air conditioners, such as window air conditioning units, and portable heaters, such as portable plug-in unit heaters, that are placed in service by the taxpayer in a taxable year beginning after 2015 may qualify. Unless, it is qualified real property, an example of an air conditioning or heating unit that will not qualify as § 179 property is any component of a central air conditioning or heating system of a building, including motors, compressors, pipes, and ducts, whether the component is in, on, or adjacent to a building as in IRC § 1.48-1(e)(2).
For qualifying property the 15 year MACRS depreciation applies to:

- Qualified Leasehold Improvement
- Qualified Restaurant Property
- Qualified Retail Improvement Property

These categories are eligible for IRC 179

It does not include any aspect of exterior improvements, building enlargements, elevators or escalators, and structural framework.
XXVII. Leasehold Improvements, Retail and Restaurant Property

The caution items:

🚫 A lease between related parties is not considered a lease.
🚫 A restaurant is a structure that dedicates more than 50% to preparation and service.
🚫 Retail property is open to the public for the sale of tangible property.
🚫 Establishments that are primarily for professional services, financial services, personal services and health care are NOT qualified.
Tommy owns a building that he rents to his healthcare corporation. With the interior suite improvements he can:

A. Take bonus depreciation
B. Take Code Sec. 179
C. Take a 15 year life
D. All of the above
XXVIII. Real Estate Improvements – Trickier than they Appear

Oh my goodness, I got:

- **Bonus Depreciation – 168(k)** – The easiest one of the bunch, cause Qualified Improvement Property is easier to qualify for than Qualified Leasehold/Restaurant/Retail
- **Expensing – 179**
- **MACRS** – Gets whatever is left over

What is the best for the taxpayer, take the pencil to it and figure it out.
XXVII. Real Estate Improvements – Trickier than they Appear

EXAMPLE: Tommy, LLC just purchased a building to rent to Healthcare Financial, Inc. Tommy and his spouse own 100% of the LLC and Tommy owns 100% of the corporation. Tommy and spouse decide to buy an older office building, originally placed in service 10 years ago, rather than buying a new building. After placing the building in service, a number of improvements are made to the building, including improving the building’s façade, replacing the old roof with a new roof, and a new office suite.

For tax purposes, the new roof and façade are 39-year property, because there is no special treatment for the exterior of the building. The LLC therefore elects partial asset disposition treatment for the cost of the old façade and roof.

For the interior suite improvements, the LLC would be entitled to use bonus depreciation provided the improvements were made after the date the building was placed in service. They would not, however, be entitled to use IRC Sec. 179 or a 15-year recovery period because it does not meet the definition of "qualified real property." Clearly his business is not a restaurant and service businesses are not eligible for qualified retail improvement property. Further, he would fail the "qualified leasehold improvement" tests because property rented to a related property is not considered subject to lease. He could potentially circumvent the related party issue if Tommy owned less than 80% of the building (including by attribution).
XXVII. Real Estate Improvements – Trickier than they Appear

Qualified Real Property Improvements
Slow down – Rev. Proc. 2017-33 – 80% or greater owners must wait for 3 years after acquisition to be eligible for “Qualified Real Property” treatment.

If Tommy did own less than 80% of the building, according to the Example 1 in Rev. Proc. 2017-33, he would not have to wait more than 3 years after the building was placed in service by the LLC to make the improvements to qualify for qualified real property treatment, because the building itself was originally placed in service more than 3 years ago by the original owner and would be eligible for Sec. 179 and a 15-year recovery period.


Oops part of the fun is done on 12/31/2019
XXIX. Safe Harbor-Costs of Remodeling-Retail Establishments and Restaurants

Qualified Retail and Restaurant Establishments have been provided under Rev. Proc. 2015-56 a safe harbor accounting method for Refresh, Remodel as deductible repairs and maintenance.

- Requires a filing of Form 3115
- Must treat 75% of qualified costs as repairs and maintenance during the year
- Bad news, the 25% portion is not eligible for partial asset disposition write-off.
- The taxpayer must have an AFS
XXIX. Safe Harbor-Costs of Remodeling-Retail Establishments and Restaurants

Excluded Establishments:
1. Automotive Dealers
2. Gas Stations
3. Manufactured Home Retailers
4. Non-store Retailers
5. Taxpayers who are in the business of operating
   - Hotels and Motels
   - Civic or Social Organizations
   - Entertainment Facilities