

# Tangible Property Regulations & the Role of Enhanced Cost Segregation

## Cost Segregation & the New Tangible Property Regulations (TPR)

- Traditional cost segregation studies focus on §1245 property
- Enhanced cost segregation studies address the new TPR's in two important ways
  1. **Dispositions:** Identifying the dispositions of structural component of buildings; i.e., those resulting from major remodel projects. This may be a significant opportunity depending on (1) how much basis is left and (2) how much is being disposed
  2. **Repairs:** Increased granularity in the reporting of §1250 assets to facilitate future repairs expensing opportunities by identifying each Unit of Property (UoP) as well as major components comprising each UoP

## Accounting for Disposed Assets §1.168(i)-8

Historically, the Internal Revenue Code generally did not permit taxpayers to recognize a loss on the disposition (retirement) of structural components of buildings, thus resulting in taxpayers (TP) concurrently depreciating both new and old assets.

Under the new TPR's, a taxpayer may recognize a retirement loss on a disposed-of component, allowing them to write off the remaining undepreciated basis.

- Partial dispositions of building components are allowed but not required. For assets disposed of by sale, exchange, or involuntary conversion, gain or loss must be recognized
- Definition - A disposition is a transfer of ownership of an asset or the permanent withdrawal of an asset from the business through:
  - » Sale or exchange
  - » Retirement
  - » Physical abandonment
  - » Destruction
  - » Transfer to a supplies, scrap or similar account
  - » **Retirement of a structural component of a building**
  - » Involuntary conversion
- Generally, the partial disposition rule is elective however, it is required to be applied in the following cases:
  - » Casualty event
  - » Gain is not recognized under §1031 or § 1033
  - » Step in the shoes transaction
  - » Sale of a portion of an asset
- Methodology - The regulations provide 3 nonexclusive examples of reasonable methods:
  1. Discounting the replacement asset's cost to its placed-in-service year cost using the Producer Price Index (or similar);
  2. Pro rata allocation of the unadjusted depreciable basis; and
  3. Study allocating the cost of the asset to its individual components (Cost Segregation)

## What is a Unit of Property (UoP) for Buildings §1.263(a)-3(e)

- The definition of the UOP is important, because it is the reference point upon which the capitalization standards are applied
- If the cost is a capital expenditure relative to a defined building component or system, it will be treated as an improvement to the building. The regulations define the building systems as:
  - » Building Structure §1.48-1(e)(1)
  - » Building Systems §1.48-1(e)(2)
    - HVAC
    - Plumbing
    - Electrical
    - All Escalators
    - All Elevators
    - Fire Protection & Alarm
    - Security
    - Gas Distribution

## Repairs vs. Capitalization §1.168(i)-8

- Amounts paid or incurred for incidental repairs & maintenance of property are not capital expenditures under §1.263(a)-1. To qualify as a repair expense, 10 tests in 3 categories must be addressed. An affirmative answer to any of the 10 tests results in a capital event
  - » **Adapt UoP to a New or Different Use §1.263(a)-3(l)**
    1. An amount is an adaptation if not consistent with the TP's ordinary use of the UoP at the time originally placed in service by the TP
  - » **Betterments §1.263(a)-3(j)**
    2. Ameliorates a material condition or material defect that existed prior to the acquisition of the UoP or arose during the production of the UoP;
    3. Material addition to the UoP (physical enlargement, expansion, or extension); or
    4. Material increase in the capacity, productivity, efficiency, strength, or quality of the UoP or its output
  - » **Restorations §1.263(a)-3(k)**
    5. Replacement & recognition of loss on disposed component
    6. Gain or loss on sale component
    7. Basis adjustment as a result of a casualty loss
    8. Return to former operating condition (no longer functioning)
    9. Rebuild the property to like new condition after the end of its class life
    10. Replacement of a part or a combination of parts that comprise a major component or a substantial structural part of a UoP
      - A major component is defined as a part or combination of parts that performs a discrete and critical function in the operation of the UoP;
      - A substantial structural part is defined as a part or combination of parts that comprises a large portion of the physical structure of the UoP



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