The Final Tangible Property Repair Regulations and Fixed Asset Review: Opportunities for 2016 and Beyond



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SOLUTIONS FOR TAX PROFESSIONALS AND BUSINESSES
TAX CREDITS • INCENTIVES • COST RECOVERY

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About KBKG, Inc.

- Established in 1999 with offices across the US, including California, New York, Chicago, Dallas, Cleveland, and Columbus.
- Provide turn-key tax solutions to CPAs and businesses.
- R&D Tax Credits, Cost Segregation, Energy Tax Incentives, Repair vs. Capitalization Studies, IC-DISC Export Incentives.
- Performed thousands of tax projects resulting in hundreds of millions of dollars in benefits for our clients.
- Our team is a diverse mix of tax specialists, attorneys, energy consultants and engineers from various disciplines. This combination of talent allows us to focus on our areas of service and maximize results for our clients.
- A preferred provider for thousands of CPAs across the country.

John Hanning, CCSP, MBA

- Director at KBKG in the Fixed Assets / Cost Segregation practice
- Member of the Accounting Methods and Credit Services Group (AMCS) specializing in Fixed Assets, Repairs & Maintenance, Construction Tax Planning and Cost Segregation Services
- Economics Management Degree - Ohio Wesleyan University
- MBA - Ohio University
- Holds his LEED Green Association credential
- ASCSP Certified Cost Segregation Specialist

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Opportunities under the PATH Act: Bonus Deprecation and 179 Expensing



- Protecting Americans from Tax Hikes (PATH) Act of 2015 retroactively reinstates for 2015 tax extenders that expired at the end of 2014, many provisions permanently renewed.
- 50% Bonus Depreciation provisions would be extended through the end of 2017 and phases down to 40% in 2018 and 30% in 2019.
- Section 179's increased expensing amounts for small businesses have been made permanent at the $500,000 level (inflation indexed).
  - Businesses exceeding a total of $2 million of purchases in qualifying equipment will have the Section 179 deduction phase-out dollar-for-dollar and completely eliminated above $2.5 million.
  - Additionally, the Section 179 cap will be indexed to inflation in $10,000 increments in future years.

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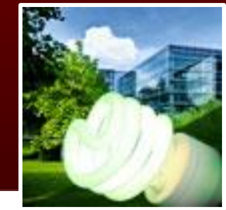
Opportunities under the PATH Act: Qualified Improvement Property



- Qualified Improvement Property (QIP) sets forth criteria making it available to a broader set of taxpayers than Qualified Leasehold Improvements (QLHI).
- QIP is defined as any improvement to an interior portion of a building that is nonresidential real property as long as that improvement is placed in service after the building was first placed in service.
- Like QLHI, items that do not qualify for QIP include expenditures for enlarging a building, any elevator or escalator, or the internal structural framework of the building.
- 39-year recovery period, bonus-eligible, no '3-year' rule, no lease requirement.
- Effective for property placed in service **after** December 31, 2015.

Opportunities under the PATH Act: Other Tax Planning Strategies


- **<u>R&D Tax Credit</u>** made permanent & modified. Additionally, beginning in 2016, eligible small businesses ($50 million or less in gross receipts) may claim the credit against their alternative minimum tax (AMT) liability, and the credit can be utilized by eligible small businesses against their payroll tax (i.e., FICA) liability.

- **<u>Sec. 179D Energy Efficiency Deductions Extended for Commercial Buildings</u>** through 2016, allows deductions of up to $1.80 per square foot. Designers of government-owned buildings remain eligible for these deductions as well. Slightly harder qualification standards for 2016 (i.e., ASHRAE 90.1-2007).

- **<u>Sec. 45L Energy Efficiency Credits Extended for Multifamily & Residential Developers</u>** through 2016. Low-rise apartment developers and homebuilders are eligible for a $2,000 tax credit for each new or rehabbed energy efficient dwelling unit.

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Retail/Restaurant Industry Safe Harbor



- Rev. Proc. 2015-56 provides a safe harbor for certain taxpayers operating retail or restaurant establishments for determining whether expenditures incurred to “remodel” or “refresh” their property can be expensed under the TPRs.
- Generally, the safe harbor benefits those enhancing the physical appearance and layout of their building to maintain a contemporary and attractive environment for their customers.
- Through the adoption of the safe harbor, retailers and restaurateurs can now take advantage of the ability to immediately deduct 75% of “qualified” amounts spent to refresh certain property and are required to capitalize the remaining 25%.

Retail/Restaurant Industry Safe Harbor



- A **qualified taxpayer** is one who has an **Applicable Financial Statement** and:
  - Is in the trade of selling merchandise, including goods to resellers such as warehouse clubs, home improvement stores.
    - **EXCLUDED:** automotive dealers, other motor vehicle dealers, gas stations, manufactured home dealers, and non-store retailers
  - Is in the trade or business of preparing and selling meals, snacks, or beverages to customer order for immediate on-premises and/or off-premises consumption.
    - **EXCLUDED:** hotels and motels; civic or social organizations; or amusement parks, theaters, casinos, country clubs, or similar recreation facilities, special food services, food service contractors, caterers, and mobile food services.

See KBKG Tax Insight Article "Retail/Restaurant Industry Safe Harbor Under Tangible Property Regulations"

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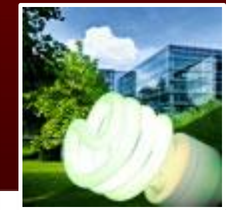
POLLING QUESTION

The Tangible Property Regulations: Repair v. Capitalization


- Determination is “highly factual”
- Guidance revolves around what constitutes the Unit of Property that is being repaired or improved.
- Must analyze each cost in the context of the <u>“Unit of Property”</u>
  - Ex. $30,000 cost for 5 new plumbing fixtures where Unit of Property (plumbing system) = small 5,000SF building; likely a capital improvement.
  - $30,000 cost for 5 same new plumbing fixtures where Unit of Property (plumbing system) = large 50,000SF building; more likely a repair.
  - Same items replaced, but facts and circumstances require a different treatment!
- Smaller the Unit of Property, more likely to capitalize

What is an “Improvement?”

An “improvement” is defined under § 1.263(a)-3(d) as an amount paid after the property is placed in service which:

1. Is a **Betterment** to the UOP
2. **Adapts** the UOP to a new or different use
3. **Restores** the UOP

B-A-R = Improvement (Capitalize)

What is the Unit of Property (UOP)?



- **Functional Interdependence** test – all the components that are functionally interdependent comprise a single UOP.

- Components are functionally interdependent if the placing in service of one component is dependent on placing in service other components

Special Rules

- Plant Property
- Network Assets
- Buildings
- Leasehold Improvements, Condo’s, Co-op

Buildings: What is the Unit of Property (UOP)?



- Building and its structural components is a single UOP § 1.263(a)-3(e)(2)(i)
- Building structure consists of “building and its structural components other than the structural components designated as ***building systems*** …” § 1.263(a)-3(e)(2)(ii)(B)

1. **HVAC**
2. **Plumbing systems**
3. **Electrical systems**
4. **All Escalators**
5. **All Elevators**
6. **Fire Protection & Alarm Systems**
7. **Security systems**
8. **Gas distribution systems**
9. **REST OF BUILDING**
   Walls, roof, floors, ceilings, windows, doors, finishes, structure, etc..

Leased Buildings - UOP



- Lessor – entire building UOP
  - For multi-tenant buildings, UOP is always the entire building
  - Must still evaluate "building systems"
- Lessee – UOP is portion of the building that is leased.
  - For multi-tenant buildings UOP is their space
  - Combine all future improvements to leased portion into the UOP being leased. Must still evaluate "building systems"

- Example - A lessee in large building remodels bathroom in their office. The expenditure is likely a capital improvement because work was done on a major portion of the plumbing system located within their office space.

- However, if lessor performed the same work, it might be a repair because work only affected small amount of the building's entire plumbing system.

Additional Rules for UOP



- Depreciation Consistency Rule
  - Component is treated as separate UOP if depreciating it as a separate class of property
  - 5, 7, 15 Year MACRS property are separate UOP from the building
- Example: Cost Segregation Study on hotel segregates Electrical System into categories with 5, 15, and 39 year lives.
  - 5 year property includes hotel decorative chandeliers and wall sconces
  - Future expenditures to replace decorative lighting are compared only to the 5 year lighting system costs; not all the lighting in the building.
- *Cost Segregation studies should summarize the buildings by Unit's of Property!!*

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What is a “Betterment?”



- Corrects a material condition or defect
- Is a material addition (enlargement, expansion, extension)
- Is a material increase in capacity, productivity, efficiency, strength, quality, or output (Ex. Replace asphalt shingles with new solar shingles)
  - Enhancement due to technological advancements not necessarily betterment. (ex. HVAC equipment is always going to be more efficient. Is it comparable?)
- “Material” - IRS has not defined this and may be an area of controversy.

“Betterment?” Examples

- Asbestos removal *<u>not a betterment.</u>*
- At time of purchasing Assisted Living Facility, taxpayer knows it needs work. Right after purchase & for a period of 2 years, while operating the facility, taxpayer pays for extensive repairs to bring facility to higher quality condition.
  - Ameliorates a previous material condition and *<u>is a betterment</u>*
- Reconfiguring office space to add more cubicles and spend $30k to add 50 more electrical outlets and V/D jacks. *<u>Is likely a Betterment.</u>*
- *<u>Not Betterment</u>* - Replace wooden shingles that are no longer available with comparable asphalt shingles that are stronger than wooden shingles. (Technological Advances)
- *<u>Betterment</u>* - Replace same shingles with lightweight composite shingles that are maintenance-free, a 50-year warranty and Class A fire rating

“Adaptation”

If you adapt something to new use it must be capitalized as an improvement

- Example – A converts its manufacturing building into a showroom for its business.
  - Replaces some lights, paints walls, and replaces other components to provide better layout for showroom and offices.
  - Taxpayer must <u>capitalize</u>

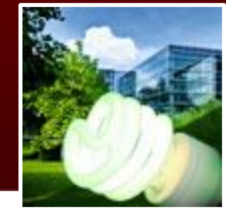
KBKG Comment: If they only did those items for their manufacturing operation, it may qualify as a repair deduction if it satisfies all other requirements and test.

What is a "Restoration?" 1.263(a)-3(k)

Restoration only if:

- Replacement of **<u>major component or substantial structural part</u>**
- Returns UOP to ordinary operating condition – if in state of disrepair & no longer functional
- Rebuilds UOP to like-new condition after end of class life
  - Class life - alternative depreciation system
- Replaces component deducted as loss; or adjusted basis taken into account for loss/gain
- Repair component after casualty loss/event if basis adjusted

Restoration



- Major Component – Parts that Perform a discrete and critical function for the building system or UOP
  - Ex. lighting, Air conditioning, flooring, water heater etc…
- Substantial Structural Part – large physical portion of building system or UOP
  - Ex. Replacing more than 50% of the lighting
- Consider all facts and circumstances – both quantitative & qualitative
  - Not just the cost, but the size, type, function etc.
- FINAL REGS: Replacement of "incidental component" of UOP will not constitute a major component even though it affects the function of the UOP
  - Example: HVAC Thermostat Controls

Restoration Examples – Roofs



X owns retail store and discovers a leak in the roof

- X replaces 60% of roof decking, roof insulation, and roof membrane.
- Restoration = improvement

Y owns factory building with roof comprised of structural elements, insulation, and waterproof membrane.

- Y replaces only roof membrane with <u>comparable</u> but new membrane. (so it's not a betterment).
- Roof membrane is a minor portion of the roof system (even though it affects the function of the building)
- Not a Restoration. Not a betterment. = Repair Expense.

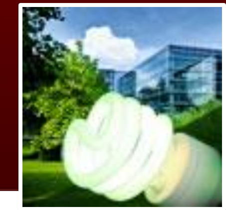
Restoration Examples

Roof
Repairs

Stair Tread
Replacement

Parking Lot
Maintenance

Restoration



- Final Regs: Restoration standards must be applied to all major components of the building or UOP
  - Must first identify the major component of a building system. Then see if a significant portion was replaced.

Example: Office building HVAC System comprised of 3 furnaces, 3 AC units, and duct work throughout the building

- 1 Furnace breaks down, replaced with a new furnace
- 3 furnaces together perform critical function for HVAC system.
- 3 Furnaces = Major Component
- However replacing a single furnace (1/3) is not a significant portion of the major component.
- Not a restoration

Restoration Examples
HVAC Systems



Example: Office building with one HVAC System

- Comprised of 1 chiller, 1 boiler, cooling tower, etc.
- Chiller is replaced with comparable unit
- Chiller functions to cool water to generate AC
- Chiller performs a discrete and critical function of HVAC system
- Must Capitalize

Assume same as above except there were 4 chillers and only one was replaced.

- Repair expense

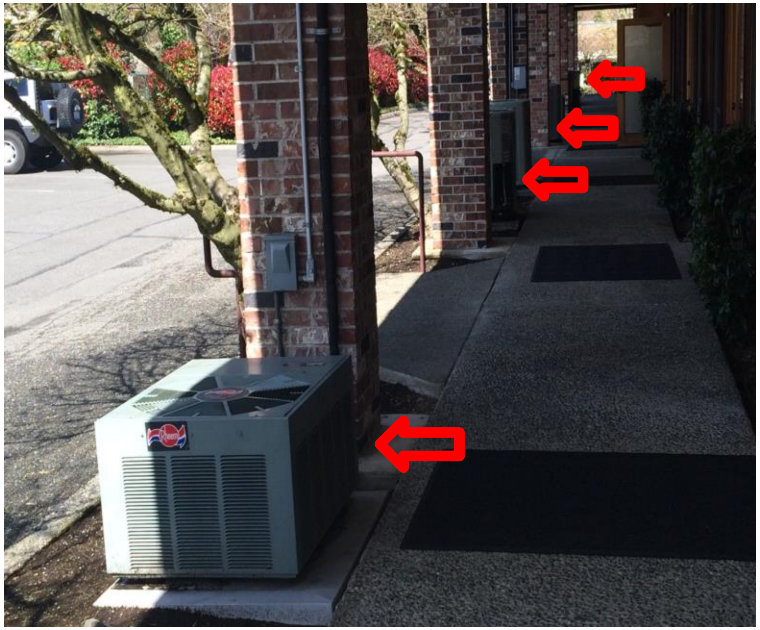
Restoration Examples
HVAC Systems



Example: Office HVAC has 10 roof top units for different areas

- Controls allow for distribution of heat or A/C to various spaces
- Building experienced climate control problems in various offices
- Owner replaced three (3) of the roof mounted units
- 10 Units are a major component of HVAC system
- Replacement of the three (3) units:
  - Not a significant portion of the major component
  - Not a substantial structural part of HVAC system
- Not a restoration. If also not a betterment, Repair Expense

Restoration Examples
HVAC Systems



Retirements and Dispositions (Final Regs Issued August, 2014)



New rules say you can now take a loss deduction when you remove anything from your building!

- Example: If you pay $50,000 for all new lighting in your building, you need to capitalize that amount over 39 years.
  - Can now calculate value of old lights and take immediate deduction for any remaining basis!

- **FINAL REGS**: “Partial Dispositions Election” is needed on timely filed tax return including extensions for year portion of asset is disposed.

Retirement of Structural Components



Example: Taxpayer acquired $5M building in 2009

- 2015 they spent $1M to remodel portion of 2nd floor (ceilings, walls, lighting, plumbing, ducting, electrical wiring, etc.)
- “Retirement Study” determines the original cost basis of demolished components is $470K (from the original $5M building)
- Recognize a loss of **$404K** (original cost basis less depreciation already taken)

Retirements create Permanent Tax Savings!



Retirements Convert Recapture Tax into Capital Gains

- If you incorrectly continue to depreciate 1245 & 1250 property that was removed from a building, you pay recapture tax upon sale
  - 1245 recapture is at ordinary rates (35%-39.6%);
  - 1250 recaptured at 25%
  - Capital Gains are typically taxed at 20%
- Note - Partial disposition of building component for normal repair is not a section 1231 loss. It is an ordinary loss.
- However retirement due to a disaster would be an involuntary conversion and is a 1231 loss.

Retirements create Permanent Tax Savings!!

Previous example – $5M building with $470K of retirements.

- If they continue to depreciate the $470K, they recapture all of it upon sale
  - Let's say $370K of that was 39 year & $100K was 7 year property
  - Recapture Tax = $127,500 ($370K * 25% + $100K * 35%)

- If they do a Retirement Study
  - Recapture tax on the $470K = 0
  - Capital gain tax = $94,000 ($470K * 20%)

- **Permanent tax savings of $33,500 upon sale**

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POLLING QUESTION

Removal Costs / Demolition



- **Old Rule:** Removal costs of an asset component needed to be capitalized with the new component.
- **New Rule:** Removal Costs of an asset component can be deducted if taxpayer realizes gain/loss on old component for tax.

Example: Landlord owns a 3 unit commercial building and pays $200K for improvements in each space in year 1.

- In year 5, one tenant leaves and new tenant requires landlord to gut and renovate the space costing $340K
  - Contractor cost detail shows $40K “demolition” cost to remove old improvements
  - Landlord can expense the $40K demolition costs and deduct remaining portion of $200K cost for the old tenant.

Determining the Basis of Removed Building Component



Final Disposition Regulations:

- Can use a cost segregation study
- Can discount the cost of a replacement component to its placed-in-service year using the Producer Price Index (PPI)
  - Can be used for restorations but **PPI can not for betterments or adaptations.**
  - *Betterment Ex:* Replace old standard roof with more expensive solar reflective roof. Cannot discount cost of new solar roof.
  - *Adaptation Ex:* Replace HVAC in old office to convert into restaurant. Cannot discount cost of new restaurant HVAC to determine old stuff.
- **Use KBKG PPI Asset Search Tool to find index data**
  - **www.kbkg.com/ppi-search-tool**

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KBKG Caution: Discounting Method



Is useful but can grossly overstate retirement loss deduction if building component is replaced within 10 years of building's acquisition.

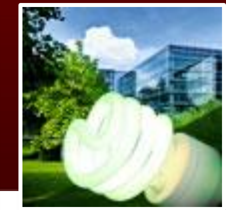
- Does not account for condition of building component at time of acquisition.

- ***Example:*** building acquired 3 years ago. Owner spent $200,000 to replace aluminum windows this year. Discount windows 3 years with PPI index = $186,000 for removed windows.
- However, this represents value of brand new windows. Windows had 3 years of life left. Appropriate "condition factor" should be applied.
- Normal life of aluminum windows is 20 years. Appropriate condition factor is 27%,* resulting in a value of $50,220 ($186,000 × 27%).

See BNA Tax Article "Dispositions of Tangible Property – IRS Restricts use of Discount Value Approach"

*condition factor and normal life obtained from valuation resource tables

Plan of Rehabilitation is Obsolete



- **Old rule** said that if you did repairs to building as part of bigger rehab project, you had to capitalize.
- **New Rule** – Repair and maintenance costs "*<u>not incurred by reason of improvement</u>*" can be expensed. As long as the repair work had nothing to do with the improvements, you can expense.

  - Example 1 – B spends $500,000 to rewire building and for new lights. Because of electrical work, there was $30K of cost to cut some drywall, patch, and paint areas rewired.
    - All $530K is capitalized
  - Example 2 – B spends $500,000 to rewire the building and upgrade electrical. B spends $30K to paint and patch areas of the building unrelated to the electrical improvements
    - $30K can be expensed if it was repair unrelated to any improvement

Tax Planning Opportunities under the New Rules

- Taxpayer spent $3M on “Renovations” in 2010, KBKG performed a Cost Seg leaving $2.5M left in 39 year category.

- KBKG review of construction doc’s - included work to “roof” (shingles replaced), “acoustic ceilings” (for only small portion of building), “asphalt paving” (for patching and resealing), “HVAC” (2 of 20 units replaced)…

- Based on new rules - $350K should be repair deductions.

- Recognize additional **$328K** on tax return by filing Form 3115. (original cost basis less depreciation already taken)

- **Permanent Tax Savings of $17,500 upon sale** by avoiding recapture ($350K * .25 - $350K * .20)



Routine Maintenance Safe Harbor

- Expense if you reasonably expect (at time placed in service) to perform more than once during class life (alternative depreciation system)
  - **Safe harbor does not apply to Betterments, Adaptations** (see Reg. § 1.263(a)-3(i)(3))

- **FOR BUILDINGS:** must reasonably expect to perform more than once during the *ten year* period from when the building system was placed in service.
  - Ex. Expense - Every 5 years the escalator hand rails are replaced

- **KBKG Commentary**: It can fail safe harbor and still be considered an expense!
  - Ex. Every 12 years we replace HVAC unit. Fails Safe Harbor but can still satisfy the BAR standards.

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Routine Maintenance Safe Harbor – Refractory Brick Example

QUESTIONS & ANSWERS



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- Repair v. Capitalization
- Property Tax
- Sales & Use Tax