2023 ASCSP Conference

- Presidents Room
- Crystal Gateway Marriott
- Arlington, VA
- November 3, 2023

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Break-out Session Junior Level - Tangible Property Regulations (TPR) Overview

John W. Hanning, MBA, CCSP

- Founding Principal of Specialty Tax Group (STG)
- Responsible for technical operations of all practice areas
- ASCSP Certified Cost Segregation Professional, #C0139-10
  - Past President 2021 – 2023
  - Board President 2019 – 2021
  - Treasure 2017 – 2019 & 2023 – 2025
  - Member of Education Committee 2010 – 2015
- 20 years of experience in the cost segregation industry
- Ohio University – Masters MBA
- Ohio Wesleyan University – Economics (BA)

Candace Orr, CCSP

- Director of Tax Accounting Methods & Credits Department at Source Advisors
- Responsible for overseeing Tangible Property Regulation Studies, Tax Reviews of Cost Segregation Studies & Management review of 3115s
- ASCSP Certified Cost Segregation Professional, #C031-17
  - Board of Directors 2021-2023
  - Member of Testing Committee 2022 – current
- 20 years of experience specializing in fixed assets
- 10 years of experience in the cost segregation industry
- University of Texas at Arlington – BBA
- Dallas College - Advance Technical Certificate in Professional Accountancy

AGENDA

01 Tangible Property Regulations Overview

02 Safe Harbors

03 Unit of Property, Major Component & Substantial Structural Part

04 Repairs vs Improvements

05 Dispositions

06 Form 3115, Change in Accounting Method

Why Discuss the Tangible Property Regs?

1. Due to state tax non-conformity, businesses leave money on the table by relying exclusively on bonus depreciation or § 179 expensing.
2. Not all capital expenditures are eligible for bonus depreciation or § 179 expensing.
3. A cost treated as a repair expense instead of a depreciable asset avoids depreciation recapture upon the sale of the property.
4. For most 3115s filed in 2014-2015, the 5-year item eligibility rule now allows automatic changes.

Overview

- Tangible Property Regulations final version released September 2013
- Applicable for taxable years on or after January 1, 2014
- Included what costs must be Capital and which can be "Expensed"
- Included Transaction Costs (facilitative cost)
- Included "Routine Maintenance" safe harbor
- Included Materials & Supplies
- Included Expensing under De Minimis Safe Harbor
- Defined the Unit of Property
- Introduced the "BAR" test for improvement costs

Tangible Property Regulation Overview

Generally effective for years beginning on or after January 1, 2014

Routine Maintenance Safe Harbor

- Routine maintenance is maintenance to keep an asset in its ordinarily efficient operating condition
- Non-building Routine Maintenance Safe Harbor
- Routine Maintenance expected to be performed more than once during UoP's class life.
- Class life generally is the Alternative Depreciation System class life
- Building Routine Maintenance Safe Harbor
- Routine Maintenance expected to be performed more than once during the 10-year period beginning with when the UoP is placed into service by the taxpayer.

Examples Include:

- Inspections
- Cleaning
- Testing
- The replacement of parts of the Unit of Property (UoP) with comparable & commercially available & reasonable replacement parts

Small Taxpayer Safe Harbor

- Election to not capitalize repairs, maintenance, or improvements
- Taxpayers with three-year average gross receipts not to exceed $10 million
- Owned or leased buildings with cost less than $1 million
- All costs cannot exceed the lessor of:
  - 2% of the unadjusted basis of the building, or
  - $10,000
- Annual election (irrevocable)
- Building-by-building analysis

De Minimis Safe Harbor Election

- Elect to apply de minimis to deduct amounts paid to acquire or produce property as taxpayer does for financial accounting purposes (book)
- Property costing less than a specified dollar amount, or
- Property with a useful life of 12 months or less
- Taxpayer has an Applicable Financial Statement (AFS)
- Must have a written accounting policy in place at the beginning of the taxable year
- Amount does not exceed $5,000 per invoice or per item
- Taxpayer does not have an AFS
- Policy in place at the beginning of taxable year consistent with taxpayer's books and records
- Amount does not exceed $2,500 per invoice or per item (eff. 1-1-2016)
- Requires an annual election; written statement filed with tax return
- Does not include or applied to
- Amounts paid for land
- Rotatable, temporary, or stand by emergency spare parts

De Minimis Safe Harbor Example

<u>Non AFS & Policy</u>

- Taxpayer has AFS
- Policy = $2,500
- Purchase:
  - 50 Computers @ $400 each
  - 50 Chairs @ $100 Each
- *Taxpayer may treat full amount as expense*

<u>Non AFS & No Policy</u>

- Taxpayer does not have AFS
- Policy = $2,500
- Purchase:
  - 50 Computers @ $2,600 each
  - Total Invoice = $130,000
- *Not eligible for safe harbor; capitalize*

<u>AFS & Written Policy</u>

- Taxpayer has AFS
- Policy = $5,000
- Purchase:
  - 50 Computers @ $2,600 each
  - Total Invoice = $130,000
- *Taxpayer may treat full amount as expense*

What is a Building Unit of Property?

- What is a “UoP”? §1.263(a)-3(e)
- The UoP is the reference point upon which the capitalization standards are applied.
- The smaller the UoP, the more likely that costs incurred for the UoP will have to be capitalized
- Non-Building UoP – Except for network or plant assets, all components that are functionally interdependent comprise a single UoP.
- Components are functionally interdependent if the placing in service of one component by the TP is dependent on the placing in service of the other component by the TP.
- Building UoP - each building & its structural components generally is one UoP
- Amounts are treated as paid for an improvement to a building if they improve: (1) the building structure; or (2) any designated building system.
- The 10 tests are applied to each building system
- If the cost is a capital expenditure for that building system, it will be treated as an improvement to the entire building.

Unit of Property

Systems	Major Components of Building Systems
HVAC	Air handling units, boilers, condensing units, fans, furnaces, heat exchangers, heat pumps, make-up air units, refrigeration compressors, water chillers, etc.
Plumbing	Bathtubs, piping, pumps, sinks, toilets, urinals, water heaters, etc.
Electrical	Generators, light fixtures, panel boards, safety switches, switchboards, transformers, etc.
Elevators & Escalators	Car, cables & pullies, control equipment, handrails, stairs, and wheels
Fire Protection & Alarm	Alarms, emergency exit signs & lights, heat & smoke detection devices, sprinkler heads & mains, water piping, etc.
Security (Building)	Alarm systems, electronic access systems, locks, monitoring devices such as cameras, etc.
Gas Distribution	Meters & gas distribution pipes

Building UoPs:
- Building structure
- Condos and co-ops
- Leased buildings and portions of buildings

Non-Building UoPs:
- Plant Property
- Network Assets
- Leased non-building property

Major Component & Substantial Structural Part

- Restoration tests for buildings often depend on the definitions of major components & substantial structural part
- Major component - focuses on the function of the component in the 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;
- Building major components may include all windows, all doors, the roof, etc.
- HVAC system major components may include all rooftop units, boilers, etc.
- Substantial structural part - focuses on the size of the replacement component in relation to 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

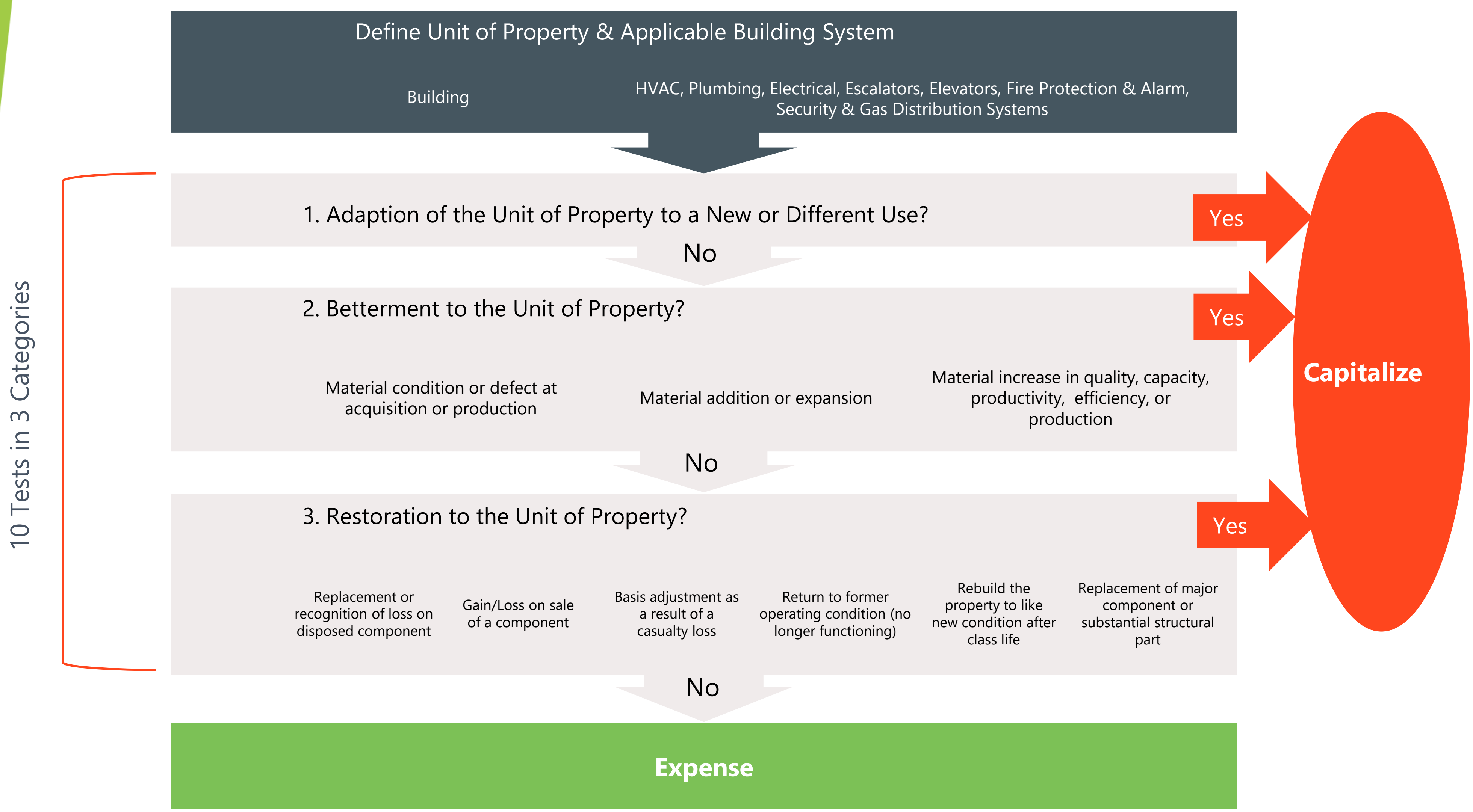
Major Component & Substantial Structural Part

- No bright line tests for determining major components.
- Examples show that the replacement of 30% - 40% of a major component (such as replacing 8 of 20 sinks) does not constitute the replacement of a major component
- Multi-year projects must be taken into account in their totality
- Replacing 30%-40% of a major component in one year may be ok; but if it is a precursor to replacing more/all of a major component over multiple years it would constitute a replacement of that major component and must be capitalized
- Foreknowledge and intent is important

Repairs vs. Improvements

- §263(a) states that no repairs deduction is allowed for:
- Any amount paid out for new buildings or permanent improvements or betterments made to increase the value of any property, or
- Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance has been made.
- §263(a) Regulations state that capital expenditures include amounts paid or incurred for betterments, adaptions to a new or different use, and restorations.
- § 1.162-4(a) allows amounts not otherwise required to be capitalized under §263(a) to be deducted as repairs.

Repairs vs. Improvements



Repairs vs. Improvements

- Leasehold or Tenant Improvements (ATG Insights)
- Breaking out § 1245 assets from § 1250 improvements is the first step when dealing with TI's.
- A newly acquired § 1245 asset like a desk, carpet, or a file cabinet is capitalized as the acquisition of a new asset/UoP when replacing prior tenant improvements. (These assets still may qualify for expensing under another provision, like the DMSH, §179, or bonus depreciation.)
- After breaking out § 1245 assets, taxpayers then apply the BAR tests to § 1250 improvements.
- The Service views § 263A as an independent capitalization provision.
- A tenant improvement that is not an improvement under the BAR tests might require capitalization under § 263A.

Betterment

Capitalized Cost

Amelioration of pre-existing condition or defect	Addition (enlargement, expansion, extension increase in capacity	Material increase in the quality, capacity, productivity, strength, or efficiency
Remediate land for contamination from leaks in underground gasoline storage [Example 1)	TP adds a stairway and mezzanine for the purpose of adding additional selling space within its building [Example 19]	Reduce energy cost by adding new insulation [Example 21]

Deductible Repair Cost

Not amelioration of pre-existing condition or defect	Not an addition (enlargement, expansion, extension increase in capacity	Nota a material increase in the quality, capacity, productivity, strength, or efficiency
Asbestos removal [Example 2]	Remove drop ceiling, and repaint original ceiling [Example 18]	Replace 2 if 10-roof-mounted HVAC units [Example 20]

Betterment – UoP Bldg. Examples

Real Property	Expenditure	UoP	Decision
Restaurant – Stand Alone	Refinish wood floors	Building Structure	Expense
Restaurant – Shopping Mall (leased space)	Replace water piping in kitchen	Lease portion of building plumbing system	Expense
Retail Store – Owned	Replace all RTU HVACs	HVAC System	Capital
Retail Store - Lease	Paint exterior of building	Leased portion of building structure	Expense
Manufacturing Plant	Relocate and replace lighting fixtures	Building structure	Expense
Manufacturing Plant	Replacement of entire roof (including decking)	Building Structure	Capital

Betterment – Refresh/Remodel

Example 6: Refresh	Example 7: Building refresh; limited improvement	Example 8: Major remodel
Consists of cosmetic and layout changes to store interior, and general repair and maintenance to modernize building	Assume same facts as example 6 plus:	Assume same facts as example 7 plus:
Replacing and reconfiguring display tables and racks; including moving walls, relocating lighting and repairing floors to accommodate redesign	Increase in buildings footprint by constructing new loading dock and adding second overhead door	Replace exterior walls with windows; rebuilding and removing walls, rebuild facades
Lighting relocations; replacing damaged ceiling tiles	Upgrade electrical system to provide lighting and power to new space	Replace vinyl flooring with ceramic tile; replace ceiling tile with acoustical tile
Repainting; patching holes in walls; replacing damaged ceiling tiles		Remodel bathrooms with higher quality material
Cleaning and repairing wood flooring		Replace the escalators; add an elevator
Power washing building exteriors		Upgrade electrical to increase capacity
Refresh activities are not betterment	Cost related to example 6 (refresh) are not capitalized; Costs associated with the addition are a betterment and capitalized in accordance with 263a	The physical nature of the work and the effects of the building structure and system results in betterment of building's structure and several of its systems

Restoration

UOP	Restoration Major component or substantial structural part	Not Restoration Not a major component/substantial structural part
Building Structure - Roof	Replacement of the entire roof (decking, insulation) [Example 14]	Replacement of roof waterproof rubber membrane [Example 15]
HVAC System	Replace chiller in office HVAC system (consists of one chiller, one boiler, pumps, duct work, diffusers, air handlers) [Example 17]	Replacement of one furnace – HVAC system consists of three furnaces, duct work, etc. [Example 17] Replacement of three of 10 rooftop units in HVAC system – HVAC system consists of 10 rooftop units, ductwork, etc. [Example 18]
Electrical System	Replace wiring throughout the building to meet building code [Example 20]	Replace 30% of wiring to meet building code [Example 21]
Plumbing System	Retail business replaces the plumbing fixtures in all restrooms (no piping) – two floors [Example 22]	Replace eight of 20 sinks in restrooms in a retail store (no piping) [Example 23]
Building Structure - Restroom	Hotel replaces all bathtubs, sinks in hotel rooms in four of the 20 floors; intends to complete renovation of the remaining rooms over next two years [Example 24]	
Building Structure - Windows	Replaces 200 of the 300 exterior windows (total windows are 25% of the building surface area) [Example 26]	Replace 100 of 300 exterior windows (windows cover 25% of exterior surface) [Example 25]
Building Structure - Floors	Replace all floors in the public areas of a hotel – public areas represent 40% sq ft [Example 28]	Replace flooring in lobby – 10% of the sq ft of the entire hotel building [Example 29]

Breathe, Stretch and Take a Break

Adaptation

An amount paid to adapt UOP to a new or different use if the adaption is not consistent with the TP's ordinary use of the UOP at the time originally placed in service.

New or Different Use

- Manufacturing plant to showroom space
- Develop land used for manufacturing plant as residential housing
- Retail drug store converts area of pharmacy to walk-in medical clinic

<u>Not</u> a New or Different Use

- Three leased retail spaces into one leased retail space
- Preparing building for sale
- Hospital modifies emergency room to also provide outpatient surgery clinic

Typical Qualifying R&M Deductible Expenditures

Doors/Windows - Replacing or repairing door closers, locks, handles and glass, laminate covering on interior doors, and existing windows or window glass
Electrical - Replacing or repairing transformers or circuit breakers, light fixtures, ballasts or bulbs, existing conduit and wire, switches and receptacles
Exterior Bldg. - Repainting the building's exterior, repairing roof leaks or replacing the roofing membrane, repairing or replacing gutters and downspouts, and resealing or recaulking existing exterior components
Floor/Wall - Replacement of sections of drywall on existing walls, repainting existing areas, replacing existing handrails attached to walls, and tile replacement
HVAC - Replacing defective or damaged component parts such as; line driers, sensors, compressors, condenser coils, fan motors, blowers, and heat exchangers, and separate RTU units
Plumbing - Replacing piping, unclogging or cleaning out existing piping, replacing existing valves, traps and drains, sinks, urinals, toilets, replacing existing water heaters, and repairing or replacing plumbing equipment to real property
Restrooms - Replacing or repairing partitions, fixtures, dryers, or any hardware associated with these items
Security/Fire - Replacing or repairing control panels, wiring, replacing batteries, recharging extinguishers, replacing sprinkler heads, and replacing other components of the system
Doors/Windows - Replacing or repairing door closers, locks, handles and glass, laminate covering on interior doors, and existing windows or window glass

Typical Qualifying R&M Deductible Expenditures

- Personal Property
- Typically the replacement of each Sec. 1245 property is capital
- Amount paid to <u>re</u>finish, <u>re</u>locate, and <u>re</u>install property can be expensed. The "re-words" are a trigger.
- Land Improvements
- <u>Re</u>striping, <u>re</u>paving, minor <u>re</u>pairs to sidewalk, curbing etc.
- Removal of landscaping
- Repairs to irrigation system (e.g. replace heads, replace small portion of piping)
- Repairs or replacement of portion of fence
- Pool <u>re</u>surfacing, misc. pool repairs

Typical Qualifying R&M Deductible Expenditures

Example 13. Not a betterment; new roof membrane. M owns a building that it uses for its retail business. Over time, the waterproof membrane (top layer) on the roof of M's building begins to wear, and M began to experience water seepage and leaks throughout its retail premises. To eliminate the problems, a contractor recommends that M put a new rubber membrane on the worn membrane. Accordingly, M pays the contractor to add the new membrane. The new membrane is comparable to the worn membrane when it was originally placed in service by the taxpayer. Under paragraphs (e)(2)(ii) and (j)(2)(ii) of this section, an amount is paid to improve a building unit of property if the amount is paid for a betterment to the building structure or any building system. The roof is part of the building structure under paragraph (e)(2)(ii)(A) of this section. The condition necessitating the expenditure was the normal wear of M's roof. Under paragraph (j)(2)(iv) of this section, to determine whether the amounts are for a betterment, the condition of the building structure after the expenditure must be compared to the condition of the structure when M placed the building into service because M has not previously corrected the effects of normal wear and tear. 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 under paragraph (j)(1)(ii) of this section as compared to the condition of the structure when it was placed in service. Moreover, the new membrane is not reasonably expected to materially increase the productivity, efficiency, strength, quality, or output of the building structure under paragraph (j)(1)(iii) of this section as compared to the condition of the building structure when it was placed in service. Therefore, M is not required to treat the amount

Typical Qualifying R&M Deductible Expenditures

Example 16. Not a replacement of major component or substantial structural part; HVAC system. M owns a building in which it operates an office that provides medical services. The building contains one HVAC system, which is comprised of three furnaces, three air conditioning units, and duct work that runs throughout the building to distribute the hot or cold air throughout the building. One furnace in M's building breaks down, and M pays an amount to replace it with a new furnace. Under paragraphs (e)(2)(ii) and (k)(2) of this section, an amount is paid to improve a building if the amount is paid to restore the building structure or any building system. The HVAC system, including the furnaces, is a building system under paragraph (e)(2)(ii)(B)(1) of this section. As the parts that provide the heating function in the system, the three furnaces, together, perform a discrete and critical function in the operation of the HVAC system and are therefore a major component of the HVAC system under paragraph (k)(6)(i)(A) of this section. However, the single furnace is not a significant portion of this major component of the HVAC system under paragraph (k)(6)(ii)(A) of this section, or a substantial structural part of the HVAC system under paragraph (k)(6)(ii)(B) of this section. Therefore, M is not required to treat the amount paid to replace the furnace as a restoration of the building under paragraph (k)(1)(vi) of this section.

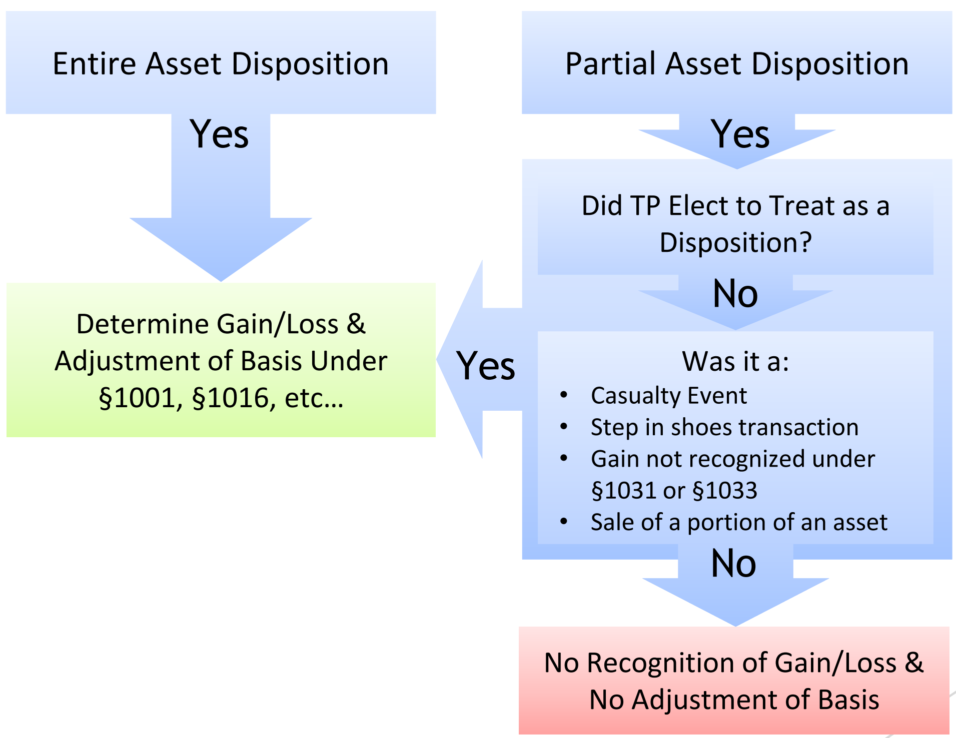
Dispositions

- 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
- Dispositions regs. apply to Single Asset Accounting (SAA), Multi Asset Accounting (MAA) & General Asset Accounting (GAA) rules

Dispositions

- Dispositions of entire assets are not elective
- Partial dispositions are generally elective however required in cases of:

- Casualty Event
- Step in shoes transaction
- Gain not recognized under §1031 or §1033
- Sale of a portion of an asset



Dispositions

- Method for identifying dispositions:
- The TPR require taxpayers to use any reasonable method to determine disposed assets in a GAA, MAA or portions of a larger asset. The choice of a reasonable method is an accounting method election.
- Non-exclusive examples of reasonable methods:
  1. Discounting the cost of the replacement asset to its placed-in-service year cost using the Producer Price Index;
  2. A pro rata allocation of the unadjusted depreciable basis of the GAA or MAA, as applicable, based on the replacement cost of the disposed asset and the replacement cost of all of the assets in the GAA or MAA, as applicable; and
  3. A study allocating the cost of the asset to its individual components

Dispositions

§280B - Demolition of Structures

- Adjusted basis & demolition costs of a demolished building are capitalized to a non-depreciable land account

Rev. Proc. 95-27 provided a Safe Harbor for §280B

- Work on a building is not considered a demolition as long as both:
  1. 75% or more of the existing external walls are retained as internal or external walls, &
  2. 75% of more of the existing internal structural framework is retained in place

Dispositions

GAA Elections & § 280B

- On a timely filed return for the year a building is placed in service, a Taxpayer (TP) can elect to place a single building into a General Asset Account (GAA)
- Generally, cannot take partial Asset Dispositions (PAD) for assets in a GAA.
- If a TP intends to demolish a building a few years after the acquisition, elect GAA status for the building.
- When the building is demolished, §280B will not apply.
- Instead, the building keeps depreciating over 27.5 or 39 years.

Form 3115, Change in Accounting Method

Automatic Method Changes

- Must be filed from the first day of year of change through extended date of return
- No acknowledgement of filing (IRS will not respond)
- No user fee

Nonautomatic Method Changes

- Taxpayer must file during year of change
- Taxpayer filing is acknowledged by IRS
- User fee is charged
- IRS must manually review and consent to change

Form 3115

- Form 3115 is filed by the taxpayer when a change in accounting method occurs

- Duplicate Filing Requirement
  - Form 3115 is attached to tax return
  - A separate signed copy must be sent to IRS (Ogden, UT)
  - Temporary COVID procedure: you may also fax your duplicate copy of Form 3115 for an automatic change in accounting method to the IRS at 844-249-8134.

- TPRs typically requires two separate 3115s
  - DCN #7 & #244 for Depreciation (Concurrent Filing)
  - DCN #184 for Repairs and Maintenance

Form 3115

Method No. 7:

- The Applicant reclassified assets originally treated as nonresidential real property having a 39 year GDS recovery period to §1245 property having a 5 year GDS recovery period classified under Rev. Proc. 87-56, Asset class 57.0 – Distributive Trades and Services.

- The Applicant also reclassified assets originally treated as nonresidential real property having a 39 year GDS recovery period to §1245 property having a 5 year GDS recovery period classified under Rev. Proc. 87-56, Asset class 00.12 – Information Systems.

- The Applicant reclassified assets originally treated as nonresidential real property having a 39 year GDS recovery period to §1250 property having a 15 year GDS recovery period classified under Rev. Proc. 87-56, Asset class 00.3 – Land Improvements.

Method No. 244:

- The Applicant reclassified assets originally placed into service after December 31, 2017 and treated as nonresidential real property having a 39-year GDS recovery period to qualified improvement property having a 15 year GDS recovery period.

Method No. 184:

- A change to deducting amounts paid or incurred for repair and maintenance in accordance with §1.162-4, including a change, if any, in identifying the unit of property under §1.263(a)-3(e) or, in the case of a building, identifying the building structure or building systems under §1.263(a)-3(e)(2) for purposes of making the change to deducting the amounts. The Applicant improperly capitalized general building maintenance and repair projects performed prior to the current tax year when treatment as immediately deductible repairs is appropriate. The Applicant calculated a §481(a) adjustment to correct such treatment.

481(a) Adjustment - Example

Attachment to Form 3115, Application for Change in Accounting Method
GDS Section 481(a) Adjustment

Accumulated Deprecation as of 12/31/2017 prior to CSS	383,137
Accumulated Deprecation as of 12/31/2017 after CSS	637,285
Total Section 481(a) Adjustment	254,148

A favorable adjustment is input into the Form 3115, Question 25 as a negative number.

OR

Section 481(a) Adjustment

Cumulative depreciation and/or amortization claimed on assets being changed as of December 31, 2021 under the **present** method	$	50,925
Depreciation and/or amortization allowed on assets being changed as of December 31, 2021 under the **proposed** method		
Personal Property – 57.0	($	439,337)
Land Improvements – 00.3	($	443,001)
Building – RP27.5	($	31,636)
Difference (negative §481(a) Adjustment)	**($**	**863,049)**