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Accounting

Gian Pazzia, a principal with KBKG, and Alex Bagne, a director, suggest that under the IRS's rules on dispositions of tangible property, taxpayers can realize significant benefits by identifying building components that have been replaced or demolished in current or prior years. The authors say the discounting method can be useful for situations where specific components are replaced with similar components and the appropriate additional adjustments are made.

Dispositions of Tangible Property—IRS Restricts Use of Discount Value Approach

BY GIAN PAZZIA AND ALEX BAGNE

In August, the IRS issued final regulations (T.D. 9689) on dispositions of tangible depreciable property under tax code Section 168 that are generally effective for taxable years beginning on or after Jan. 1, 2014. Taxpayers can realize significant benefits from these regulations by identifying building components that have been replaced or demolished in current or prior years.

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One notable change from the proposed regulations relates to "reasonable" methods taxpayers may use to determine the basis of a disposed asset component. In addition to using a cost segregation study, the IRS states that one reasonable method could be discounting the cost of a replacement component to its placed-in-service year using the Producer Price Index (PPI). The Consumer Price Index (CPI) under the proposed regulations is no longer allowed. While this approach can be used for certain restorations, *the final regulations do not allow this method to be used for betterments or adaptations.*

CAUTION: KBKG believes this method can be useful for restorations but cautions taxpayers and certified public accountants that this method may not result in a logical value when a building component is replaced within 10 years of a building's acquisition. Because this method doesn't account for the condition of the building component at the time of acquisition, it may grossly overstate the taxpayer's retirement loss deduction.

Practical Examples.

Example 1: A building was acquired three years ago, and $200,000 was incurred to replace all the aluminum windows in the current year. Discounting the replacement window cost back three years using the PPI index yields a value of $186,000 for the old windows.

However, this would represent the value of new windows at that time. Since these windows had only three years of life left, an appropriate ''condition factor'' should be applied. Since the normal life of aluminum windows is 20 years,* the appropriate condition factor should be 27 percent,* resulting in a more appropriate value of $50,220 ($186,000 x 27 percent).

*condition factor and normal life obtained from valuation resource tables

The unadjusted value significantly overstates the taxpayer's allowable retirement deduction. It is important to note the IRS isn't obligated to accept an estimate of component basis using the PPI discounting method if it doesn't result in a reasonable value.

Other factors that can cause a material overstatement under the PPI discounting method include whether the building was purchased at a discount or involves a basis adjustment. The regulations account for this by suggesting ''a pro rata allocation of the unadjusted depreciable basis of the asset based on the replacement cost of the disposed portion of the asset and the replacement cost of the (entire) asset.''

Example 2: Assume the same facts as Example 1, except that the building that was acquired three years ago out of foreclosure at a discounted price of $1.5 million (excluding land). The cost to reconstruct the building three years ago was $2.5 million. Since all the building components were purchased at a 60 percent discount, the basis of the old windows is reduced to $30,132 ($50,220 x 60 percent).

If there was a tax basis adjustment to the building, such as required in a Section 1031 tax-free exchange, an additional reduction factor must be applied.

Example 3: Assume, in addition to the facts in Examples 1 and 2, the building was acquired through a Section 1031 exchange, reducing its tax deprecation basis to $750,000. Since the basis reduction must be applied to all the building components, the relative basis of the windows should be reduced further by another 50 percent, bringing it to $15,066 ($30,132 x 50 percent).

Since the PPI discounting method isn't accepted by the IRS for any betterments and adaptations, CPAs must be careful to appropriately apply this method for their clients.

Below are examples where the discounting method can't be used to value components removed:

- any expansion or upgrade to a facility, (Treasury Regulations Section 1.263(a)-3(j)(1));
- renovations to a recently purchased assisted-living facility incurred over two years while the facility is operating (Treas. Reg. Section 1.263(a)-3(j)(3), Example 5);
- extensive remodeling of the interior of a retail store (Treas. Reg. Section 1.263(a)-3(j)(3), Example 8);
- addition of a mezzanine and stairway in a retail store (Treas. Reg. Section 1.263(a)-3(j)(3), Example 19);
- addition of a drive-through service area in a restaurant (Treas. Reg. Section 1.263(a)-3(j)(3), Example 22);
- conversion of a manufacturing building to a showroom (Treas. Reg. Section 1.263(a)-3(l)(3), Example 1);
- reconfiguring a pharmacy to create a clinical area (Treas. Reg. Section 1.263(a)-3(l)(3), Example 5);
- landlord installation of leasehold improvements for new tenant business activity; and
- improvements to a building where items were replaced with components of a higher quality, strength or efficiency.

The IRS has provided some guidelines on how taxpayers can easily obtain historical component basis numbers for restorations. The discounting method can be useful for situations where specific components are replaced with similar components and the appropriate additional adjustments are made. When significant renovations are made that encompass the removal, replacement and addition of several components, a third-party expert analysis should be considered.

» Access KBKG's PPI Component Disposition Calculator

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