Repair vs. Capitalization

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- We're made up of tax, construction, and engineering professionals.
- Years of experience:
 - Cost Segregation Studies since 1996
 - §179D certifications since 2006
 - §45L certification since 2008
 - Repair vs. Capitalization analyses since 2008

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We have these guys...

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... and these guys...





So that when it comes time to save money on your property or design and build projects you don't look like this guy.



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With over fifteen years' experience and more than 6,500 studies completed, MS Consultants has established itself as one of the industry leaders in cost segregation services, energy consulting, LEED' green building certification, 1790 analysis, and much more. Our experienced team of construction, engineering, and tax experts have completed projects ranging in size from small tenant build-outs to major sports venues—and everything in between. We've worked with over 300 accounting firms across the US, and generated millions of dollars in tax benefits for real estate clients. How did we become the nation's leading cost segregation study provider for small, local, and regional CPA firms? That's simple: trust . Over 80 percent of our work comes from repeat customers, because our clients know that when they call us, they can count or: The technical expertise to apply the detailed engineering-based approach preferred by the IRS to your project; The proven experience to generate reports that meet or exceed IRS standards for cost segregation studies and produce outstanding audit results;				Estimate
Our unique 3R Approach to cost segregation studies; Our Tumkey Process , which minimizes the amount of time our clients need to devote to the project and its paperwork;			A Visual Introduct	tion to Cost Seg

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Main Ideas to Take Away

- Confusion new rules are long, complex, and confusing
- Additional work required by CPAs <u>and</u> clients
- More assets need to be capitalized under new regulations

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Main Ideas to Take Away (con't)

- Ability to write off structural components as they are replaced
- Unique opportunities for General Asset Accounts (GAA)

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History of Repair vs. Capitalization

- 2004: Advance notice of proposed rulemaking
- 2006: Proposed regulations amendments proposed under §263(a)
- 2008: Earlier (2006) regulations withdrawn, new regulations proposed
- 2011: New temporary regulations put forth, effective tax years 2012beyond
- 2012: Additional guidance issued (Revenue Procedures 2012-19 and 2012-20)

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- May 9, 2012: IRS hearing for public comments on new regulations
- Nov 20, 2012: IRS issues Notice 2012-73, delaying mandatory adoption of repair regulations until 2014

Repair vs. Capitalization

Let's go back to the old rules.

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The Old Rules-What is Capitalized?

- You are required to capitalize expenditures that:
 - Materially increase the value of the property
 - Substantially prolong the useful life of the property or

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• Adapt the property to a new or different use Excerpted from Reg. 1.263(a)-1(b)

The Old Rules, con't

"The cost of <u>incidental</u> repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as an expense . . . Repairs in the nature of <u>replacements</u>, to the extent that they <u>arrest deterioration and appreciably prolong</u> <u>the life of the property</u>, shall . . . be capitalized and

depreciated."

<u>Reg. 1.162 -4</u>

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The Old rules

"Some items are clearly capital and other items are clearly expense, but between the two extremes a point is approached at which it is difficult to determine whether the expenditure is capital or expense"

- Libby & Blouin, LTD., 4 BTA 910 (1926)

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The Old Rules, con't

"To fix a door or patch plaster might very well be treated as an expense when it is an incidental minor item arising in the use of the property carrying on business, and yet, as here, be properly capitalized when involved in a greater plan of rehabilitation, enlargement and improvement of the entire property."

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- I.M. Cowell, 18 BTA 997 (1930)

The Old rules-con't

"An expenditure which returns property to the state it was in before the situation prompting the expenditure arose, and which does not make the relevant property more valuable, more useful, or longer-lived, is usually deemed a deductible repair. A capital expenditure is generally considered to be a more permanent increment in the longevity, utility, or worth of the property."

-Plainfield Union Water Co., 39 TC 333 (1962)

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The Old rules-con't

Many court cases fought over the words "materially" and "substantially"

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Then Came the Recent Cases

R.L. Smith

- Smelting cells house the electrolysis process used to produce primary aluminum
- Taxpayer expenses new cells for aluminum smelting operations. Cells are part of 800 cell system



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Then Came the Recent Cases

R.L. Smith – Some Background on Aluminum Smelting

- Alumina is dissolved in molten cryolite at 1,832 degrees F.
- The electrolyte is placed in an iron vat lined with graphite. The vat serves as the cathode.
- Carbon anodes are immersed in the electrolyte.
- Electrical current is passed through the molten material.
- At the cathode, electrolysis reduces aluminum ions to aluminum metal. At the anode, carbon is oxidized to form carbon dioxide gas. The overall reaction is:

 $2AI_2O_3 + 3C \rightarrow 4AI + 3CO_2$

 Molten aluminum metal sinks to the bottom of the vat and is drained periodically through a plug

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R.L. Smith

- IRS wins each cell is unit of property
- Taxpayer argued that each cell was part of a larger system

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Ingram Industries

• Taxpayer expenses new engines and overhauls for tugboats





Ingram Industries

• Taxpayer wins -Tugboat is unit of property

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 IRS argued that engines were unit of property

FEDERAL EXPRESS CORP., DC-TN, 2003-2 USTC

- Taxpayer expenses engine replacement and repair to cargo planes
- IRS argued an engine was a unit of property... how useful does this plane look right now?



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FEDERAL EXPRESS CORP., DC-TN, 2003-2 USTC

- Taxpayer expenses engine replacement and repair to cargo planes,
- This looks a bit safer.



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FEDERAL EXPRESS CORP., DC-TN, 2003-2 USTC

Taxpayer wins – plane is unit of property
 You try flying on a plane without engines.

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What has happened since Fed Ex?

- In 2004, The IRS requested comments:
 - "The Service and the Treasury Department want to provide clear, consistent and administrative rules that will reduce the uncertainty and controversy in this area . . ."
- In 2006 the Treasury issued their first set of proposed regulations. These were withdrawn in 2008 and replaced with a new set of proposed regs. Under the 2008 Prop. Reg. 1.263(a)-3(d)(2)(ii) -Buildings and their structural components as defined under Sec. 1.48-1(e) are a single unit of property.

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What has happened since Fed Ex?

- Many taxpayers began filing Form 3115 "Change in Accounting Method" before the proposed regulations become final. Due to the large amount of Form 3115s being filed, the IRS formed a task committee to best determine how to handle this issue.
- And on August 27th, 2009, the IRS decided to help taxpayers

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What has happened since Fed Ex?

- Rev. Proc. 2009-39
 - Automatic Approval
 - Due with Tax Return
 - No Filing Fee
 - For tax years ending on or after December 31, 2008

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Repair vs. Capitalization Under the Old Rules

Write off the remaining tax basis of items that were capitalized that should have been expensed as a repair instead (with Form 3115 automatic approval):

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- Roofs
- Garage Doors
- Parking Lots
- HVAC
- Outside Painting/Powerwashing
- Hot Water Heaters

New IRS Regulations on Repair vs. Capitalization

 On December 23, 2011, the IRS issued the long-awaited Repair vs. Capitalization regulations that will have significant impacts on a wide range of industries. These new rules, effective for the tax years beginning in 2012, are far-reaching and will probably affect all of your taxpayers who own businesses or real estate.

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• However, on November 20, 2012, the IRS responded to commentary by releasing Notice 2012-73, delaying the mandatory implementation of the new rules until 2014.

New IRS Regulations on Repair vs. Capitalization

- New regulations are long, complex, and confusing
 - Compared to the approach provided in the 2008 proposed regulations, the approach contained in these temporary regulations produces results that are more consistent with current law and as a result of court cases

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Affected Code Sections

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- §162-Materials and Supplies
- §168-Depreciation and Dispositions
- §263(a)-Acquisition and Improvements

The New Regulations

- The standards for applying §263(a), as set forth in the regulations, case law, and administrative guidance, are difficult to discern and apply in practice and have led to considerable controversy for taxpayers.
- To comply with the new rules a vast majority of taxpayers will need to file Form 3115 "Change in Accounting Method"

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Agenda

1. Determining the Unit of Property

- 2. Applying the Capitalization standards
- 3. Write-off of Structural Components and Other MACRS Property

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- 4. Remodeling Expenditures (Plan of Rehabilitation Doctrine)
- 5. MACRS General Asset Accounts(GAA)
- 6. New rules on "Materials & Supplies" (M&S)
- 7. "Official" de minimis rule
- 8. Facilitative Expenses
- 9. Other changes to the rules
- **10.** Then came the new Rev Procs

1. Determining the Unit of Property Temp. Reg. §1.263(a)-3T(e)

- Building and its structural components are a single UOP
 - The temporary regulations define the building structure as the building (as defined in §1.48-1(e)(1)) and its structural components (as defined in §1.48-1(e)(2)) other than the components specifically enumerated as building systems.

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1. Determining the Unit of Property Temp. Reg. §1.263(a)-3T(e)

- **UOP for buildings.** In general, each building and its structural components is a UOP "the building" and the improvement standards are applied at the building & building system level.
- Amounts are treated as paid for an improvement to a building if they improve: (1) the building structure; or (2) any designated building system.

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 This new term consists of the following nine structural components. Each of them (including their sub-components) is a building system that is separate from the building structure, and to which the improvement rules must be separately applied:

At the end of the day you end up with

• Building structure: roof, walls, floors, windows, doors, etc. and

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• 9 Building Systems

- 1. HVAC system (Heating, Ventilation and Air Conditioning)
- 2. Plumbing Systems inside and outside, including water, storm and sewer and related fixtures
- 3. Electrical System inside and outside, including fixtures, wiring, and distribution

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- 4. Escalators
- 5. Elevators

- 6. Fire protection (sprinklers) and Alarm Systems
- 7. Security Systems for the protection of the building and its occupants
- 8. Gas Distribution System inside and outside
- 9. Other Structural Components identified in future published guidance that are specifically designated as building

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- Example: Replacement of major component or substantial structural part; elevator.
 - Taxpayer owns a \$10M building that is used to operate its business, and pays \$50,000 to repair an elevator in the building. If the amount paid results in a restoration of the building structure or any building system, the taxpayer must treat the amount as an improvement to the building. The elevator is a building system and is valued at \$200,000.

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• Result = Costs are CAPITALIZED (the elevator system is the unit of property.)

- Example: Not a replacement of major component or substantial structural part; plumbing system.
 - Taxpayer owns a building in which it conducts a retail business. The retail building has three floors. The retail building has men's and women's restrooms on two of the three floors. X only pays an amount to replace three of the twenty sinks located in the various restrooms because these sinks had cracked. The three replaced sinks, by themselves, do not comprise a large portion of the physical structure of the plumbing system nor do they perform a discrete and critical function in the operation of the plumbing system.
 - Result = Costs are EXPENSED (the sinks do not constitute a major component or substantial structural part of the building system)

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- UOP for leased property. Each building and its structural components(Landlord or Lessor) or the portion of the building subject to a lease and the structural components associated with the leased space(Lessee or Tenant)
- Improvement standards are applied at the leased portion of the building and building systems subject to the lease.

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UOP in Leased Buildings

- Lessor incurs cost for tenant improvements
 - The costs are included in UOP of the building
- Lessee incurs costs for tenant improvements
 - The costs are the UOP of the leased space, not of the entire building.

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- Example:
 - Tenant wants a new HVAC unit and leases 10% of the space. There are 12 HVAC units on the building.

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- If tenant pays, tenant must capitalize
- If landlord pays, costs can be expensed
- Note: This could impact common area maintenance charges(CAM)

• UOP for assets other than buildings. In general, for real or personal property that isn't classified as a building by the temp regs. all the components that are functionally interdependent comprise a single UOP. Components of property are functionally interdependent if the placing in service of one component by the taxpayer is dependent on the placing in service of the other component by the taxpayer.

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- **UOP for Plant property.** Functional interdependence test is used to determine UOP
- Discreet and major function standard must be applied.
- Each machine is typically treated as it own UOP
- Applies to manufacturing, power generation, distribution and warehousing

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- **UOP for personal property.** Functional interdependence test is used to determine UOP.
- Capitalization depends on facts and circumstances

- Routine Maintenance Safe Harbor
- Ongoing activity that a taxpayer expect to perform more than once during the class life of the UOP - to keep the UOP in ordinary and efficient operating condition

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Routine Maintenance Safe Harbor

- Does not apply to Buildings
- Does not apply if retirement loss is claimed
- Does not apply if gain or loss was recognized on sale

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Does not apply to restoring to ordinary efficient operating condition

Routine Maintenance Safe Harbor

Example: Taxpayer acquires an agricultural machine with an ADS class life of 10 years for its farming operations. The manufacturer of the machine recommends scheduled maintenance every three years, which includes the cleaning, oiling, inspecting, and replacement of minor items such as bearings and seals. The taxpayer performs the maintenance 3 times in 10 years.Rev. Proc. 87-56, Table B-1 states that this assets falls under Asset Class 01.1, Agriculture with a MACRS life of 7 years and an ADS life of 10 years.

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• Result = Costs are EXPENSED

- Example-cont:

Table B-1. Table of Class Lives and Recovery Periods

	Recovery Periods (in yea			
Asset class	Description of assets included	Class Life (in years)	GDS (MACRS)	ADS
SPECIFIC DEPRECIABLE ASSETS USED IN ALL BUSINESS ACTIVITIES, EXCEPT AS NOTED:				
01.1	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.	10	7	10

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Agenda

- **1.** Determining the Unit of Property
- 2. Applying the Capitalization standards
- 3. Write-off of Structural Components and Other MACRS Property

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- 4. Remodeling Expenditures (Plan of Rehabilitation Doctrine)
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- **10.** Then came the new Rev Procs

2. Applying the Capitalization standards: Temp. Reg. §1.263(a)-3T

- **BETTERMENT** of the Unit of Property
- ADAPTS the Unit of Property to a new or different use.

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• **RESTORATION** of the Unit of Property

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Old rules verse the new rules

- OLD
 - Materially increase the value of the property
 - **Substantially** prolong the useful life of the property or
 - Adapt the property to a new or different use

• New

- Betterment of unit of property
- Adapt the property to new or different use
- Restoration of unit of property

BETTERMENT of the Unit of Property

- 1- Ameliorate a material condition or defect that existed prior to the acquisition of the property or arose during the production of the property;
- 2- Material addition to the unit of property (including the physical enlargement, expansion, or extension);
- 3- Material increase in the capacity, productivity, efficiency, strength, or quality of the unit of property or its output

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BETTERMENT of the Unit of Property

- 1- Ameliorate a material condition or defect that existed prior to the acquisition of the property or arose during the production of the property.
 - Example 1: Taxpayer acquires an assisted living facility and are aware of conditions that are below their standards. The work includes repainting; replacing flooring materials, windows, and tiling and fixtures in bathrooms; and replacing window treatments, furniture, and cabinets.

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– Result = Costs are CAPITALIZED (Betterment)

BETTERMENT of the Unit of Property-con't

- 2- Material addition to the unit of property (including the physical enlargement, expansion, or extension);
 - Example 1: Taxpayer owns a 100,000 SF manufacturing building that needed to extend the production area for their growing business. They construct a 30,000 SF addition.

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– Result = Costs are CAPITALIZED (Betterment)

BETTERMENT of the Unit of Property-con't

- 2- Material addition to the unit of property (including the physical enlargement, expansion, or extension);
 - Example 2: Taxpayer owns a factory building with limited office area, they extend the office into the existing storage area by cleaning, painting, and replacing ceiling and floor tile.

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Result = Costs are EXPENSED (not a Betterment)

BETTERMENT of the Unit of Property-con't

• 2- Material addition to the unit of property (including the physical enlargement, expansion, or extension);

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 Example 3: What if the taxpayer adds a 3,000 square foot addition to the existing 100,000 square foot building?

BETTERMENT of the Unit of Property-con't

- 3- Material increase in the capacity, productivity, efficiency, strength, or quality of the unit of property or its output
 - Example 1: Taxpayer owns a factory building with a storage area on the 2nd floor, they replace columns and girder supports to permit greater weight capacity in the area for new products.

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– Result = Costs are CAPITALIZED (Betterment)

BETTERMENT of the Unit of Property-con't

- 3- Material increase in the capacity, productivity, efficiency, strength, or quality of the unit of property or its output
 - Example 2: Taxpayer owns an office building with a 1st floor drop ceiling, they decide to remove this and repaint the original ceiling.

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– Result = Costs are EXPENSED (not a Betterment)

RESTORATION of the Unit of Property

 A taxpayer must capitalize amounts paid to restore a unit of property, including amounts paid in making good the exhaustion for which an allowance is or has been made.

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RESTORATION of the Unit of Property-cont

- 1. Replacement of a component of a UOP and the taxpayer has properly deducted a loss for that component;
- 2. Replacement of a component of a UOP and the taxpayer has properly taken into account the adjusted basis of the component in realizing gain or loss resulting from the sale or exchange of the component;

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RESTORATION of the Unit of Property-cont

- 3. Repair of damage to a UOP for which the taxpayer has properly taken into account the basis adjustment as a result of a casualty loss under Sec. 165 or relating to and event described in Sec. 165;-different from old casualty rules
- A. Returns the UOP to its ordinarily efficient operating condition if the property has deteriorated to a state of disrepair and was no longer functional for its intended use;

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RESTORATION of the Unit of Property-cont

• 5. Results in the rebuilding of the UOP to a like-new condition after the end of its asset class life;

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• 6. Replacement of a major component or a substantial structural part of the UOP;

Adapts the property to a new or different use:

Same as the old rules

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Adapts the property to a new or different use

- Example 1 New or different use:
 - Taxpayer is a manufacturer and owns a manufacturing building that it has used for manufacturing since 2000. In the current year, the taxpayer pays an amount to convert its manufacturing building into a showroom for its business which involves removing and replacing various structural components to provide a better layout for the showroom and its offices. The amount paid to convert the manufacturing facility into a showroom adapts the building structure to a new or different use because the conversion is not consistent with their intended ordinary use of the building structure at the time it was placed in service.
 - Result = Costs are CAPITALIZED (adaptation of the building structure as an amount that improves the building)

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Adapts the property to a new or different use

- Example 2 Not a new or different use:
 - Taxpayer owns a building consisting of twenty retail spaces. The space was designed to be reconfigured; that is, adjoining spaces could be combined into one space. One of the tenants expands its occupancy to include two adjoining retail spaces. To facilitate the new lease, the taxpayer pays an amount to remove the walls between the three retail spaces. The amount paid to convert three retail spaces into one larger space for an existing tenant does not adapt the building structure to a new or different use because the combination of retail spaces is consistent with the intended, ordinary use of the building structure.
 - Result = Costs are EXPENSED (amount paid by the taxpayer to remove the walls does not improve the building)

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Accounting Method Changes

- Change to capitalize amounts paid for improvements to units of property consistent with Temp. Reg. Sec. 1.263(a)-1T and 1.263(a)-3T
- 2. Change from capitalizing to deducting as repairs under Temp. Reg. §1.162-4T amounts paid for tangible property

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3. Change from capitalizing to deducting amounts that qualify for the routine maintenance safe harbor

Agenda

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- 8. Facilitative Expenses
- 9. Other changes to the rules
- **10.** Then came the new Rev Procs

3. Write-off of Structural Components and Other MACRS Property - Temp. Reg. §1.168-8T

- "taxpayer may use any reasonable method that is consistently applied for . . . determining the unadjusted depreciable basis of the assets disposed."
- Sounds Simple?
- The Regulations spend 14 pages just on dispositions of MACRS property

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3. Write-off of Structural Components and Other MACRS Property

- Identify the item being replaced without construction records or a cost segregation study to support your position?
- Regs specifically state that the asset disposed of cannot be larger than the UOP – for example, how much of the original "roof" was replaced? Can you identify the original HVAC units that were replaced?

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3. Write-off of Structural Components and Other MACRS Property

Example: Client acquires \$5M building in 2005

 In 2010 \$1 million is expended to remodel area of 1st floor that included new lighting, ductwork and electrical

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- Next step is to determine cost of assets removed
- Original cost basis of demolished components is \$400,000
- Taxpayer incurs a loss of \$325,000 in 2012 (cost basis, \$400,000, less accumulated depreciation, \$75,000)
- Taxpayer required to file Form 3115

3. Write-off of Structural Components and Other MACRS Property

Change in Accounting Method

The following automatic change in accounting methods relating to buildings and structural components are added to the Appendix of Rev. Prov. 2011-14 by Rev. Proc. 2012-20:

- 1. A change to identify the appropriate asset disposed of
- 2. A change from capitalizing an asset previously disposed of (e.g. structural component) to recognizing gain or loss

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3. A change from an improper method of identifying assets disposed of from multiple asset account (e.g. LIFO) to a proper method

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4. Remodeling Expenditures

- Goodbye, Plan of Rehabilitation Doctrine
 - The temporary regulations obsolete the plan of rehabilitation doctrine to the extent the court created doctrine provided different standards for determining whether an otherwise deductible cost must be capitalized as part of an improvement.

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4. Remodeling Expenditures-con't

- <u>Building Refresh</u> "cosmetic changes" to the Structural Component - Repair
 - Example: Taxpayer owns a retail store and periodically changes the layout/appearance to keep the store modern and attractive to customers. The work is not undertaken for the purpose of repairing damaged property but rather to renew the appearance of the property.

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Result = Costs are EXPENSED (not a Betterment)

4. Remodeling Expenditures-con't

- <u>Building Refresh, Limited Improvement</u> the above, plus new bathroom fixtures – Capitalize Bathrooms (Plumbing), Other costs can be deducted as an expense
 - Example: Taxpayer owns retail store and periodically changes the layout/appearance to keep the store modern and attractive to customers. *Taxpayer also* removes and replaces fixtures along with wall and floor tile within the restroom facilities.

Result =

- Refresh costs are EXPENSED (not a Betterment)
- Plumbing costs are CAPITALIZED (Structural/Building system)

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4. Remodeling Expenditures-con't

- <u>Building Remodel</u>—everything is Capitalized (all Structural Components).
 - Example: Taxpayer owns a retail store and work performed to refresh the stores directly benefits or was incurred by reason of a substantial remodel to the taxpayer's store buildings. Taxpayer reconfigures, repairs, as well as performs cosmetic changes. The reconfiguration involves removing and rebuilding walls for changing rooms and specialty departments and replacing carpet for ceramic tile and finally updates the electrical system.

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• Result = Costs are CAPITALIZED (Structural/Building system)

4. Remodeling Expenditures-Example

Example:

- Taxpayer incurs \$5 million on renovations in 2008 and capitalized and depreciated the renovations
- Next step is to analyze the costs to determine if any can be expensed under the new rules
- Determined that \$700,000 of costs qualify as repairs
- Taxpayer receives a \$500,000 deduction in 2012 (cost of \$700k basis less accumulated depreciation of 200k)

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• File form 3115

Agenda

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The Benefits

- Taxpayer can now elect to terminate GAA treatment for qualifying assets under a wider variety of circumstances than under the old regs
- Taxpayer can now benefit from treating similar assets as one asset for depreciation purposes and the flexibility to remove an asset from the account when it produces better tax result
- Could result in less gain or more loss upon disposition
- "Encourages" buildings to be placed in GAA
- Potentially expense "repair" items and not write-off replaced components

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• Avoids potential "allowed verse allowable" issues

- Qualifying assets
 - Personal Property
 - Land Improvements
 - Buildings
- Assets must have same depreciation method, recovery period and convention. Under the old rules asset were required to be in same asset class. Couldn't mix computers with cars
- Taxpayer may end up with one or multiple GAA due to above or may choose based on taxpayer preference
- Can only group assets based on the following:
 - Luxury Auto's
 - Other Listed Property
 - Same First year Additional Deprecation clamed (30%, 50& or 100%)
 - Mass Assets Relating to Mortality Dispersion Tables
 - Assets Subject to Different Depreciation Calculation (short year or a more accelerated depreciation method)

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5. MACRS General Asset Accounts(GAA) §168(i)(4)

• Making the GAA Election

• Made on taxpayer's timely filed return (including extensions) income tax return for the tax year in which the assets included in the GAA are placed in service

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- Depreciation and Amortization Form 4562, check the box, line 18
- GAA election is irrevocable. Exceptions do apply
- Elections made by each member of a consolidated group, at the partnership level or at the S-Corporation level

- Optional Termination of GAA Treatment for Dispositions-Qualifying Assets
- A qualifying disposition is a disposition that does not
 - Involve all assets
 - The last asset and
 - Is not an involuntary conversion
 - Is not subject to a like-kind exchange
 - Not a technical termination of a partnership
 - Not an abusive transaction
- New rules are more flexible than the old rules, thus encouraging more taxpayers to take advantage of.

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• Example:

 A calendar-year partnership buys a \$10 million office building in 2012, and maintains one GAA for it. In 2017, the partnership discovers a leak in the roof of the building and, after consulting with a contractor, decides to replace the entire roof. The remaining adjusted basis of the old, removed roof is \$150,000. The removal of the old roof is a qualifying disposition under the temp regs and the partnership may elect to terminate GAA treatment for the old roof and thereby recognize a loss on its disposition.

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• Note: Under the old rules an election could not have been made because the retirement of a building component wasn't allowed as a disposition

- Results of Optional Termination of GAA Treatment for Dispositions
- The gain or loss for the asset is determined under §1.68(i)-8T
- GAA treatment for the asset terminates as of the first day of the tax year in which the qualifying disposition occurs
- The unadjusted depreciable basis of the GAA is reduced by the unadjusted depreciable basis of the asset being disposed as of the first day of the tax year

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• Accumulated depreciation is treated the same way

Example:

Philco, a calendar-year corporation, maintains one GAA for 12 mall sweepers it bought in 2012 for \$15,000 and placed in service that year. Philco depreciates this GAA using 5 year life with 200% declining balance. As of January 1, 2014, the depreciation reserve for the GAA is \$93,000 (\$180,000 total cost x (.20 first-year table allowance + .32 second-year table allowance)). On may 27, 2014, Philco sells three of the machines to an unrelated party for \$5,000 each. The sale is a qualifying disposition and Philco elects to terminate GAA treatment for the three machines.

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Example, con't

- The following are the results of Philco's election:
 - As of Jan. 1, 2014, the unadjusted depreciable basis of the GAA is reduced from \$180,000 to \$135,000 (\$180,000 less the unadjusted depreciable basis of \$45,000 for the three machines).
 - As of Dec. 31, 2013, the depreciation allowed or allowable for the three machines is \$23,400 (\$45,000 x (.20 first year table allowance + .32 second year table allowance)). Thus, the GAA's depreciation reserve is decreased from \$93,600 to \$70,200 (\$93,600 less \$23,400).
 - The GAA's depreciation allowance for 2014 is \$25,920 (\$135,000 x (.192 third year table allowance)).
 - On Philco's 2014 return, gain or loss for each of the three sold machines is determined as follows. The depreciation allowed or allowable in 2014 for each machine is \$1,440 [(\$15,000 x .192 third year table allowance) / 2 (on account of the half-year convention)]. Thus, the adjusted depreciable basis of each machine is \$5,760 (the adjusted depreciable basis of \$7,200 removed from the account less the depreciation allowed or allowable of \$1,440 in 2014). As a result, the Code Sec. 1231 loss recognized in 2014 for each machine is \$760 (\$5,760 adjusted depreciable basis \$5,000 amount realized).

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(Adapted from the example at reg. §1.168(i)-1T(e)(3(iii)(D))

- Assets in a GAA must be identified when taxpayer elects optional termination treatment
- IRS has 5 specific identification rules
 - 1. Specific identification
 - 2. FIFO
 - 3. Modified FIFO
 - 4. Mortality Dispersion table
 - 5. Methods designated by IRS after December 23, 2014

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- Retroactive GAA elections
- Rev Proc. 2012-20 allows taxpayers to retroactively elect to place existing assets into a GAA for a taxpayers first and second tax years ending after December 31, 2011



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- Why election is important
- Disposition rules trump betterment and restoration capitalization standards
- If you don't elect GAA you must capitalize replacement
- If you don't elect GAA you must write-off disposed asset
- If you elect GAA you can decide whether to capitalize using the betterment and restoration standards
- If you elect GAA you can decide whether to write-off disposed assets

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Change in Accounting Methods

The following automatic change in accounting methods relating to GAAs are added to the Appendix of Rev. Proc. 2011-14 by Rev. Proc. 2012-20:

- 1. Moving assets within one GAA account to another GAA account
- 2. A change to identify the appropriate asset disposed of
- 3. Change in proper method of identifying assets disposed of from a multiple-asset GAA account to another proper method
- 4. A change from improper method of identifying assets disposed of from GAA (e.g. LIFO) to a proper method

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- 5. Late GAA election for assets placed in service in tax years beginning before 2012
- 6. Late election to recognize gain or loss on disposition of all assets or last asset in GAA
- 7. Late election to recognize gain or loss in a qualifying GAA disposition



Multiple Asset Accounts-(MAA)

- Generally subject to same rules as GAA
- Difference-gain or loss always recognized when asset is disposed in MAA
- Difference-MAA terminates when last asset sold. GAA continues until end of recovery period
- Difference-No mandatory rules for termination of MAA
- Used my taxpayers with many assets that will be held to end of recovery period.

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Multiple Asset Accounts-(MAA)

Change in Accounting Method

Rev. Proc. 2012-20 adds new section 6.28 to the Appendix of Rev. Proc. 2011-14 to provide the following automatic accounting method changes relating to item and multiple asset accounts:

- 1. Change from single asset accounting to multiple asset accounting or vice versa
- 2. Moving assets within one asset account to another multiple asset account
- 3. Change in manner of identifying assets disposed of from a multiple asset account from one proper method to another proper method.

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6. New Rules on Materials & Supplies Temp. Reg. §1.162.3T

Materials and Supplies (M & S)

- Incidental M & S are deductible in the year they are purchased – if physical inventories are not taken, and taxable income is clearly reflected
- Non Incidental M & S are deductible in the year they are used

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- Materials and Supplies definition
 - Components acquired to maintain, repair or improve a UOP or
 - Fuel, lubricants & similar items expected to be used within the next 12 months or

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- UOP with a cost of \$100 or less or
- UOP with an economic useful life of 12 months or less

- Materials and Supplies
 - Restaurant Smallwares are not effected by these new rules
 still able to be expensed (see Rev. Proc. 2012-19)
 - Similarly, Rev. Proc. 2002-28 allows a qualifying small business taxpayer to treat certain inventoriable items in the same manner as materials and supplies that are not incidental under §1.162-3.

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- Materials and Supplies
 - Rotable or Temporary Spare Parts have several pages in the new regs – including new optional methods that need to be elected – 4 choices

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- Defer until disposed
- Apply optional method-need a math degree
- Use de minimis rule
- Capitalize and depreciate

Change in Accounting Method

Rev. Proc. 2012-19 adds the following automatic accounting method changes relating to materials and supplies to the Appendix of Rev. Proc. 2011-14:

- 1. Change to comply with definitions of non-incidental materials and supplies and deduct in year used or consumed (cut-off method applies)
- 2. Change to comply with definition of incidental materials and supplies and deduct in year paid or incurred (cut-off method applies)

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- 3. Change to deduct cost of non-incidental rotable spare parts in tax year of disposition (cut-off method applies)
- 4. Change to optional method of accounting for rotable spare parts

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7. "Official" de minimis rule – Temp Reg. §1.262-2T(g)

• Elective "de minimis" rule

> You may expense M & S in year purchased if you have

- Audited financials (no Audit, no de minimis),
- Written policy in place at the beginning of the year, and
- M&S do not exceed the greater of .1% of gross revenue or 2% of book depreciation and amortization

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7. "Official" de minimis rule, con't

Other items to note

- A taxpayer may elect to capitalize amounts that would otherwise be subject to de minimis rules.
- No written policy in effect at 1/01/12 no de minimis policy allowed for 2012.

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• Might need to capitalize for 263a purposes.

7. "De Minimis" example

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- Sales of \$100,000,000
- Depreciation and amortization of \$4,500,000
- Expenditures under the de minimis rules were \$100,000
- Sales factor equals- \$100 million times .1% = \$100,000
- Depreciation factor equals- \$4.5 million times 2% = \$90,000
- Taxpayer could deduct \$100,000
- Taxpayer and IRS can agree to higher limit
- Taxpayer can elect to capitalize

7. "Official" de minimis rule-con't

- For tax years beginning in 2012, the maximum amount that may be expensed is \$500,000, and the maximum annual expensing amount generally is reduced dollar-for-dollar by the amount of section 179 property placed in service during the tax year in excess of \$2,000,000 (the investment ceiling).
- Assets used in the de minimis rule calculation are not counted in determining section 179 investment ceiling

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7. "Official" de minimis rule-con't

Change in Accounting Method

An automatic change in accounting method procedure may be used to adopt the de minimis expensing method. The change is applied on a cut-off basis (Rev. Proc. 2012-19, adding Section 3.17 to the Appendix of Rev. Proc. 2011-14)

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8. Facilitative Expenses

- Facilitative costs include "inherently facilitative" expenses made up of 11 categories. These include the costs of items such as shipping, moving or appraising property, application fees, sales and transfer taxes, finder's fees, and architectural, engineering, environmental or inspection services related to specific properties, brokers' or appraisers' fees, and services provided by a qualified intermediary in a Code Sec. 1031 exchange.
- Costs relating to activities performed in the process of determining whether to acquire real property and which real property to acquire generally aren't facilitative expenses and therefore may be currently deductible, unless they are "inherently facilitative" expenses.
- Amounts paid for employee compensation or overhead can be expensed unless buying for resale under 263a. An election can be made to capitalize.

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• De minimis rules can be used.

8. Facilitative Expenses

Accounting Method Change

Rev. Proc. 2012-19 adds the following automatic accounting method changes relating to costs to acquire or produce property to the Appendix of Rev. Proc. 2011-14:

- 1. Change to capitalize amounts paid to acquire or produce property under Reg. Sec. 1.263(a)-2T, including defense of title and transaction costs
- 2. Change from capitalizing to deducting amounts incurred to investigate acquisition of real property (cut-off method applies)
- 3. Change from capitalizing to deducting employee compensation and overhead costs incurred to investigate acquisition of real property (cut-off method applies)

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9. Other Changes to the Rules

• Clarification that lessors and lessees must depreciate their improvements, and cannot amortize them over the life of the lease. You can even go back and fix.

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9. Other Changes to the Rules – con't

- A new rule requires taxpayers to capitalize repair-type expenses made to assets before they are placed in service." §1.263(a)-2(d)(1)
- Buy a building in 2011 but do "repairs" before building is placed in-service in 2012
- "Repairs" would be capitalized under new regs.
- Taxpayer should have placed building in-service before doing repairs

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9. Other Changes to the Rules – con't

Moving and Installation Costs

Amounts paid to move and reinstall a unit of property that has already been placed in service are not required to be capitalized under the rules for acquisition or production of property. But, if the costs of moving and reinstalling a unit of property directly benefit, or are incurred by reason of, an improvement to the unit of property that is moved and reinstalled, such costs are required to be capitalized.

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Transition guidance Issued March 7, 2012

- Rev Proc. 2012-19-changes to comply with all provisions except depreciation and dispositions
- Rev Proc. 2012-20-changes to comply with depreciation and dispositions
- Change is automatic
- 23 changes in total
- For tax years beginning on or after January 1, 2012. Certain adjustments require a "modified" cut-off method"

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• Cannot be early adopted

Transition guidance Issued March 7, 2012

- Rev. Proc. 2011-14 stays the same regarding 481a adjustments
 - If adjustment reduces income change is over 1 year
 - If adjustment increases income change is spread over 4 years
- Taxpayers receive audit protection for prior years upon filing national office copy of Form 3115-Ogden, Utah. IRS will not make examination adjustment relating to a taxpayers use of its previous method for any tax year
- The new Rev Procs waive the scope limitations
 - 5 year waiting period is waived
 - If you don't get it right the first time you can reapply
- Single application for two or more concurrent changes. The Rev Procs allow for multiple changes on a single From 3115 application
- For tax years beginning on or after January 1, 2012
- Cannot be early adopted
- Scope Limitations waived for 1st and 2nd years
- Taxpayers receive audit protection for prior years upon filing national office copy of Form 3115-Ogden, Utah

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 In this Notice, the IRS has stated that while they plan on issuing Final Regulations in 2013, these regulations will now apply for tax years beginning in 2014 - allowing taxpayers and their professionals more time to learn and understand the rules than the original 2012 implementation date.

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 Taxpayers can still choose to apply these regulations for years beginning in 2012, providing tax-savings opportunities for those taxpayers who would have benefitted under the new regulations.

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Who would benefit under the new rules?

- Taxpayers with structural components that have been removed, but are still being depreciated
- Taxpayers who have remodeled or renovated in 2012 and 2013

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Additionally, the IRS specifically stated that the following areas will be changed as part of the new regulations:

- **De Minimis Rule**: § 1.263(a)-2T(g);
- **Dispositions**: § 1.168(i)-1T and § 1.168(i)-8T; and
- Safe Harbor for Routine Maintenance: § 1.263(a) -3T(g).

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GAA accounts

Below is a listing of some of the common §481 Adjustments:

• Welcome to Election Heaven or...

Change Number	Description	481 Adjustment	Comments
162	Deducting Repair and Maintenance Costs	Retroactive	Also applies to a taxpayer wishing to change its unit of property for purposes of determining whether amounts paid or incurred improve that UOP.
164	Deducting incidental materials and supplies when paid or incurred	Cutoff at 1/1/2012	Change does not apply to rotable or temporary spare parts.
165	Deducting incidental materials and supplies when paid or incurred	Cutoff at 1/1/2012	None
166	Deducting non-incidental rotable and temporary spare parts when disposed of	Cutoff at 1/1/2012	None
167	Change to the optional method for rotable and temporaryspare parts	Retroactive	None
168	Deducting dealerexpenses that facilitate the sale of property	Retroactive	Change does not apply to liabilities in curred to facilitate the disposition of assets that constitute a trade or business. See Reg. sec. 1.263(a)-5(g).

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§481 Adjustments, con't

Change Number	Description	481 Adjustment	Comments
169	Deducting de minimis amounts (capitalization threshold)	Cutoff at 1/1/2012	This change does not applyto: (1) amounts paid for property that is or is intended to be included in in ventory, (2) amounts paid for land, and (3) start-up expenditures.
170	Deducting certain costs for in vestigating orpursuing the acquisition of real property, in cluding employee compensation and overhead	Cutoff at 1/1/2012	This change does not applyto start-up expenditures.
171	Change to the safe harbor for routine maintenance on property other than buildings	Retroa ctive	This change does not applyto a building or a structural component of a building.
172	Non-dealer expense to facilitate the sale of property	Retroactive	Change does not apply to liabilities incurred to facilitate the disposition of assets that constitute a trade or business. See Reg. sec. 1.263(a)-5(g).
173	Capitalizing and depreciating acquisition or production costs	Retroactive	None
17 4	Capitalizing and depreciating improvements to tangible property	Retroactive	Change does not applyto a taxpayer that wants to change its method of a counting for dispositions of depreciable property or for any property subject to a repair allo wance. A separate schedule must be attached to the Form 3115 for the section 481(a) adjustment listing the adjustment amount for each property classification (e.g., 5-year property, 7-year property). A taxpayermaking this change must complete Form 3115, Schedule E, and attach it to the Form 3115.



§481 Adjustments, con't

Change Number	Description	481 Adjustment	Comments
175	Depreciation of leasehold improvements	Retroactive	If the change is made for public utility property, the change must be reported to the regulatory body.
176	Permissible to permissible method of accounting for depreciation of MACRS property; includes changes to/from massasset accounts and FIFO methods	See sub-table below	None
177	Disposition of a building or structural component	Retroactive	Doesnot apply to property subject to a valid general asset account election, or multiple buildings, condominium units, or cooperative units that are treated as a single building under the taxpayer's present or proposed method of accounting.
178	Dispositions oftangible depreciable assets (otherthan a building orits structural components)	Retroactive	None
179	Dispositions oftangible depreciable assets in a general asset account	See sub-table below	None
180	Generalassetaccount elections	See note sat right	A late general asset account election for one ormore items owned by the taxpayerat the beginning of the year of change is implemented using a cut-offmethod. Late elections to recognize gain or loss upon disposition of assets are implemented using a retroactive 481 adjustment.

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What the IRS wanted to accomplish when the began rewriting the regs in 2004

"The Service and the Treasury Department want to provide clear, consistent and administrative rules that will reduce the uncertainty and controversy in this area . . ."

Did the IRS accomplish their goal?

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Thank you for listening. Any further questions, contact:

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