Tangible Property Regulations

Guidebook to IRS Compliance & Tax Savings
Complementary to Cost Segregation

Most Commercial Real Estate is <u>NOT</u> Compliant

TPR eBook (54 pg) by ProfitsUSA.com

Free TPR Tax Deduction Estimate
And Compliance Audit Offer

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Who We Are, Empowering CPAs, 4 Book Sections, YouTube Video & Podcast

Who We Are

We are an AI software development company specializing in AI-powered software that combines Tangible Property Regulations (TPR) and Cost Segregation for CPAs. By partnering with the leading CPA firm for both TPR and Cost Segregation, we develop specialized AI software and educational resources for real estate owners and their CPAs.

How We Empower CPAs

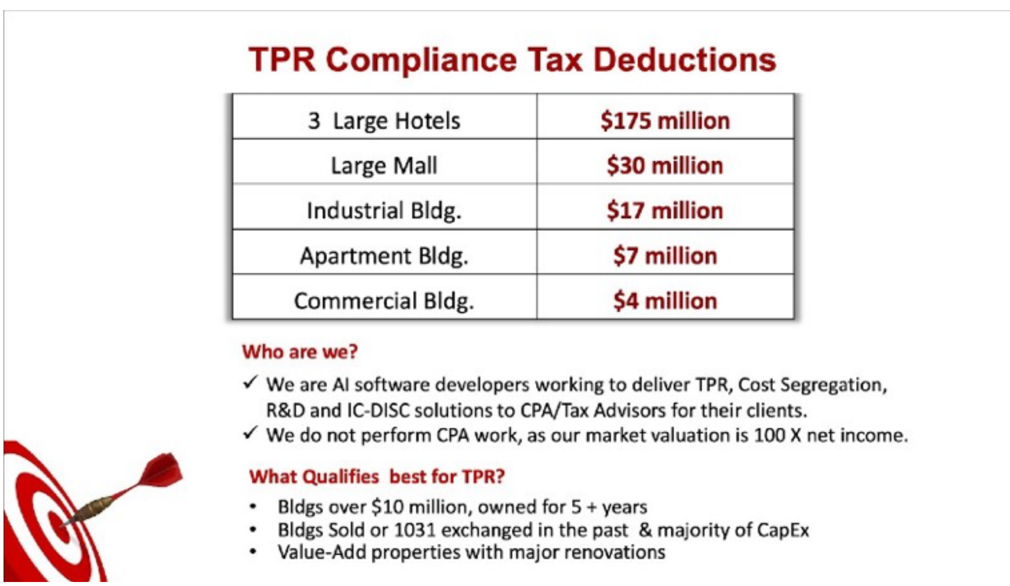
To empower CPAs by providing best-in-class AI software solutions that simplify the process of delivering optimal tax benefits to their real estate and business clients, ultimately empowering and enriching both CPAs and their clients.

- Any concern that we might take clients from CPAs is unfounded and illogical, as our market valuation as an AI software licensing firm is 100 times our net income. We are also developing AI software for healthcare and business.

Four Book Sections

1. 5-minute YouTube video below, OR our 20-minute Podcast interview on our website homepage.
2. The first 20 pages of this 48-page ebook provide the core value when combined with #1 and together are sufficient for most commercial real estate (CRE) owners & CPAs. **To find out your potential TPR tax deduction at no cost or obligation, provide us a depreciation schedule and address for any building(s) valued at over $10 million, and we will calculate TPR for you.**
3. The following 22 pages of this book provide explanations for CPAs and CRE owners.
4. A 6-page FAQ of the top 14 questions, the complete IRS FAQ (42 questions), directly linking to the IRS TPR FAQ, and a link to the IRS's 265-page Auditor's Guide for TPR.

Section 1 YouTube video or Podcast: Overview of the Value that TPR Provides



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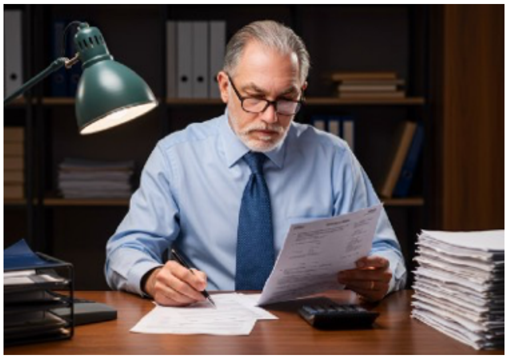
Section 1 - Backgrounder of Key TPR Concepts & Glossary

Backgrounder of 9 Key Tangible Property Regulations (TPR) Concepts



The Tangible Property Regulations (TPRs), provide a framework to determine if costs should be immediately expensed or capitalized and depreciated, offering significant tax savings opportunities and carrying severe penalties for non-compliance. Understanding the Unit of Property (UOP), Building Systems, Safe Harbors, the RABI rules, Section 481(a), and Partial Asset Dispositions (PADs) are key to compliance and maximizing benefits. Due to the complexity of TPRs, expert guidance is often essential.

Main Themes and Nine Key Ideas

1.) Purpose and Mandate of TPRs:

(A) The TPRs were written to provide a clearer framework for distinguishing between deductible business expenses (repairs) and non-deductible capital expenditures (improvements) on tangible property.

(B) They combine decades of case law and other authorities to address the subjective nature of these decisions and reduce conflicts between taxpayers and the IRS.

(C) "The Tangible Property Regulations (TPRs) provide guidelines for building owners to determine to expense or capitalize costs spent on property from 2014 forward."

(D) "Under code section 263(a)(1-3), the Tangible Property Regulations are the most significant tax change for real estate owners and investors since the Tax Reform Act of 1986."

(E) "The Tangible Property Regulations are not optional." They are mandatory for all taxpayers incurring costs on tangible property since January 1, 2014.

2.) Impact of Compliance vs. Non-Compliance:

(A) Compliance is advantageous, offering opportunities for immediate tax savings by allowing certain expenses to reduce current taxable income.

(B) Non-compliance can lead to significant financial loss, penalties, and interest charges, including the IRS denying past, present, and future depreciation claims.

(C) Correcting non-compliance may require filing IRS Form 3115 to adjust accounting methods, which can be complicated.

3.) Unit of Property (UOP) and Building Systems:

(A) Proper identification of the Unit of Property (UOP) is essential for determining how expenses are treated. Generally, each building not connected to another structure is considered an individual UOP.

(B) "The proper identification of the UOP is essential when making decisions about whether a cost should be capitalized or expensed..."

(C) Buildings are further broken down into specific Building Systems (up to nine categories, including HVAC, plumbing, electrical, fire protection systems, etc.), and each system must be accounted for separately.

(D) Understanding the value of each building system helps property owners make informed capital vs. expense decisions.

4.) Safe Harbors:

- Safe Harbors are elective, simplifying provisions that allow certain expenditures to be expensed without detailed scrutiny. They act as administrative conveniences for small items.

Three Safe Harbors allow certain expenditures to be expensed without scrutiny.

(i) **De Minimis Safe Harbor (DMSH):**

- Allows expensing of individual items under $2,500. This is an annual election requiring an invoice for the expense, with each item on the invoice being less than $2,500. Cannot be applied retroactively.

(ii) **Small Taxpayer Safe Harbor (STSH):**

- Available to taxpayers with average gross receipts of $10 million or less. Allows expensing the lesser of 2% of the building's adjusted basis or $10,000 annually. This is an annual election.

(iii) **Routine Maintenance Safe Harbor (RMSH):**

- Allows expensing costs for routine maintenance expected to be repeated within 10 years to keep an asset in normal operating condition. This safe harbor does not require an annual election. Maintenance cannot improve, enlarge, or materially increase efficiency.

5.) RABI Rules (Restoration, Adaptation, Betterment, Improvement):

- When Safe Harbors do not apply, the RABI rules are used to determine if an expenditure must be capitalized or can be expensed.

(A) **Restoration:**

- ☑ Capitalize if the expenditure occurs within two years of occupancy or the component is in total disrepair.

(B) **Adaptation:**

- ☑ Capitalize if the expenditure changes the original intended use of the asset.

(C) **Betterment:**

- ☑ Capitalize if the expenditure makes the component more than 10% more efficient, larger, or significantly more valuable.

(D) **Improvement:**

- ☑ Capitalize if the expenditure affects more than 33% of all like components. Expenditures to maintain everyday normal operating condition more than two years after occupancy can typically be expensed.

6.) Opportunities under Section 481(a):

(A) IRS Code Section 481(a) offers flexibility to revisit and adjust depreciation schedules based on current TPR rules, allowing previously capitalized repairs to potentially be expensed.

(B) "There is flexibility under IRS Code Section 481(a) for taxpayers to revisit and adjust their depreciation schedules."
(C) For businesses with less than $10 million in Average Annual Gross Receipts (AAGR), making a Section 481(a) adjustment is optional, and not doing so will not result in disallowance of future depreciation (as long as AAGR remains below the threshold). For businesses over $10 million AAGR, failure to make this adjustment was initially warned to result in disallowance of future depreciation.

(D) Eligibility for a 481(a) adjustment depends on whether the RABI rules have been followed since 2015.
•If only safe harbors were applied, the adjustment is still possible.

7.) Partial Asset Disposition (PAD):
(A) A PAD allows building owners to write down the remaining depreciable basis of items removed during a renovation, as well as the costs for removal and disposal.
(B) "A PAD allows a building owner to write down the remaining depreciable basis of items removed during a renovation, as well as the costs for the removal and disposal of those items."
(C) This provides a tax deduction in the current year but is a "use it or lose it" opportunity. Failing to write down the basis in the year of renovation permanently negates the opportunity.

8.) Relationship with Cost Segregation Studies:
(A) TPR compliance is mandatory and involves annually scrubbing depreciation schedules. Cost Segregation Studies are optional.
(B) It is often advisable to perform a TPR analysis (especially a "lookback" analysis) before a Cost Segregation Study, or about five years after a property acquisition, especially if a Cost Segregation Study has not been done.
(C) Many capitalized items that would be depreciated under a Cost Segregation Study can be reclassified as permanent expenses using TPRs, which is often more beneficial than depreciation.
(D) Before a Cost Segregation Study, ensure assets eligible for expensing under Section 263(a) are properly expensed to ensure TPR compliance.

9.) Expert Assistance and Technology:

(A) The TPRs are highly complex, and expert knowledge is crucial for proper compliance and maximizing benefits.

(B) Specialized TPR firms like our team exist to help taxpayers accurately assess their UOP, navigate expense vs. capitalization decisions, identify past expenditures eligible for expensing, and make strategic renovation decisions.

(C) AI software is being developed to assist with TPR compliance by scrubbing depreciation schedules, to empower real estate owners and their tax advisors.

Conclusion:

The Tangible Property Regulations are a critical, mandatory aspect of tax compliance for property owners. Understanding the distinction between expensing and capitalizing costs, applying the appropriate rules (Safe Harbors and RABI), correctly identifying the Unit of Property and Building Systems, and leveraging opportunities like Section 481(a) adjustments and Partial Asset Dispositions are essential for maximizing tax savings and avoiding severe penalties. Due to the complexity, engaging with experts specializing in TPRs can provide significant value and ensure full compliance.

Glossary of 18 Terms Used in This Book

- **Average Annual Gross Receipts (AAGR):** A metric used to determine eligibility for certain provisions under the Tangible Property Regulations, such as the optional nature of a Section 481(a) adjustment for businesses with less than $10 million in AAGR.
- **Building Systems:** Specific categories within a Unit of Property (UOP) that must be accounted for separately. Examples include HVAC, plumbing, electrical, and fire protection systems.
- **Capital Expenditures (Capitalized):** Costs incurred on tangible property that must be spread over a period of years through depreciation rather than being immediately deducted as an expense. These generally make an asset better.
- **Cost Segregation Study:** An analysis that identifies and reclassifies building components into shorter depreciable lives for tax purposes, potentially accelerating depreciation deductions.
- **De Minimis Safe Harbor (DMSH):** An annual election allowing taxpayers to expense expenditures under $2,500 without scrutiny, provided certain conditions regarding invoicing are met.
- **Depreciation:** The process of deducting the cost of tangible property over its useful life for tax purposes.

- **Expensing (Deductible Business Expenses):** Costs incurred on tangible property that can be fully deducted in the current tax year, typically related to repairs and maintenance that keep the asset in its current operating condition.
- **IRS Form 3115:** The form required to adjust a taxpayer's accounting methods, often necessary to correct non-compliance with the Tangible Property Regulations.
- **Partial Asset Disposition (PAD):** A tax strategy that allows building owners to write off the remaining depreciable basis and removal costs of assets disposed of during a renovation.
- **RABI Rules:** An acronym representing Restoration, Adaptation, Betterment, and Improvement. These are tests used to determine if an expenditure must be capitalized when Safe Harbors do not apply.
- **Routine Maintenance Safe Harbor (RMSH):** A provision allowing taxpayers to expense costs for routine maintenance expected to be performed regularly, typically within 10 years, without requiring an annual election.
- **Safe Harbors:** Elective, simplifying provisions under the TPRs that allow certain expenditures to be expensed without scrutiny, providing administrative convenience for small items.
- **Section 263(a)(1-3):** The code section under which the Tangible Property Regulations fall, outlining rules for distinguishing between deductible business expenses and non-deductible capital expenditures.
- **Section 481(a) Adjustment:** An adjustment made under IRS Code Section 481(a) that allows taxpayers to change their accounting methods, including revisiting and adjusting depreciation schedules based on current TPR rules.
- **Small Taxpayer Safe Harbor (STSH):** An annual election available to taxpayers with average gross receipts of $10 million or less, allowing them to expense the lesser of 2% of the building's adjusted basis or $10,000 annually for certain building improvement costs.
- **Tax Reform Act of 1986:** Mentioned as the previous most significant tax change for real estate owners and investors before the Tangible Property Regulations.
- **Treasury Decision 9636:** The Treasury Decision number associated with the final Tangible Property Regulations, issued on September 17, 2013.
- **Unit of Property (UOP):** The framework used by the IRS to determine how expenses related to repairs, improvements, or replacements of tangible property are treated for tax purposes; typically, each building is considered an individual UOP.

Quiz (Answers are below)

1. What is the primary purpose of the Tangible Property Regulations (TPRs)?
2. Why were the TPRs written and why did the IRS enact the TPRs?
3. Are the Tangible Property Regulations optional for taxpayers?
4. What is a Unit of Property (UOP), and why is its correct identification important?
5. List three examples of building systems identified in the source.
6. What is the main benefit of using a Safe Harbor under the TPRs?
7. Explain the eligibility requirements for the Small Taxpayer Safe Harbor (STSH).
8. How does the Routine Maintenance Safe Harbor (RMSH) differs from others?
9. When do the RABI rules need to be considered by a taxpayer?
10. What is a Partial Asset Disposition (PAD), and what is its key benefit?

Quiz Answers

1. The TPRs guide building owners and taxpayers in deciding whether to expense or capitalize tangible property costs, intending to clarify ambiguity and minimize disputes over repairs versus capitalization.
2. The TPRs offer a more defined framework for deciding if tangible property costs are immediately deductible business expenses or must be capitalized. These regulations synthesize extensive legal precedent to resolve the often-subjective nature of such expense versus capitalization determinations.
3. No, the Tangible Property Regulations are mandatory for all taxpayers who incur costs to acquire, improve, or produce tangible property. Compliance is required since January 1, 2014.
4. A Unit of Property (UOP) is considered each building when it is not connected to another structure. Proper identification of the UOP is essential because the IRS uses this framework to determine how expenses related to repairs, improvements, or replacements are treated for tax purposes.
5. Examples of building systems include HVAC, Electrical, Plumbing, Fire Protection & Alarm, Security, Escalators, Elevators, and Gas Distribution.
6. The main benefit of using a Safe Harbor is that it allows certain expenditures to be expensed without scrutiny. Safe harbors are administrative conveniences to avoid creating a burden for taxpayers on small items.
7. To be eligible for the Small Taxpayer Safe Harbor (STSH), taxpayers must have average gross receipts of $10 million or less. They can then expense the lesser of 2% of the building's adjusted basis or $10,000 annually.
8. The Routine Maintenance Safe Harbor (RMSH) allows taxpayers to expense costs for routine maintenance expected to be performed regularly, generally within 10 years. Unlike other safe harbors, it does not require an annual election; all taxpayers are automatically considered to follow this rule.
9. The RABI rules (Restoration, Adaptation, Betterment, Improvement) need to be considered when Safe Harbors do not apply to determine whether an expenditure must be capitalized or can be expensed.
10. A Partial Asset Disposition (PAD) allows a building owner to write down the remaining depreciable basis of items removed during a renovation, as well as their removal and disposal costs. Its key benefit is a tax deduction in the current year, but it is a "use it or lose it" opportunity.

Benefits from Being Tangible Property Regulations (TPR) Compliant

The Tangible Property Regulations (TPRs), mandated by IRS section 263(a)(1-3) in 2014:

1. Provide guidelines for classifying tangible property expenses as immediately deductible repairs or capitalized and depreciated improvements.
2. This can impact the timing of tax deductions and cash flow for taxpayers who acquire, improve, or produce tangible property.
3. Simplify compliance and reduce disagreements by transforming case law into clear directives..

This clarity enables property owners to implement optimal tax strategies, reduce tax liabilities, and ensure ongoing IRS compliance. Furthermore, TPR regulations affect a client's depreciation schedule. This impact is crucial for identifying assets with a tax-depreciable basis and exploring potential TPR method adjustments in the current or upcoming tax year.

TPRs enhance tax benefits by:

1. Increasing write-offs.
2. Lowering basis and recapture.
3. Improving ROI and net profits.

Immediate tax savings are achieved through these aspects of TPR:

1. Safe Harbor Provisions for Repairs and Maintenance.
2. Generous expense deductions reduce the overall income tax burden.
3. Minimized depreciation recapture upon property sale.

Benefits from Being Tangible Property Regulations (TPR) Compliant

The Tangible Property Regulations (TPRs) offer immediate and future tax benefits to property owners, real estate investors, and small businesses, resulting in financial and operational improvements.

- **Immediate Tax Savings:** The De Minimis Safe Harbor (DMSH) and the Routine Maintenance Safe Harbor (RMSH) allow the immediate deduction of minor expenses and routine maintenance costs.
- **Reduced Tax Liabilities:** Classifying expenses accurately based on TPR guidelines enables expense write-downs, significantly lowering taxable income.
- **Improved Cash Flow:** Expensing instead of capitalizing means more net income after paying income tax liability. This enhanced cash is available to reinvest, pay down debt, or acquire assets.

Failure to comply with TPR can lead to significant IRS penalties, including the rejection of depreciation claims and the imposition of fines. The IRS mandates an annual review and correction of depreciation schedules to avoid these consequences.

Costs & Risks of Non-Compliance with Tangible Property Regulations

- The Tangible Property Regulations (TPRs), which became mandatory on January 1, 2014, establish crucial guidelines for all taxpayers who incur expenses related to tangible property.

- These regulations mandate the proper classification of these expenses, distinguishing between those that can be immediately deducted as repairs and maintenance and those that must be capitalized as improvements and depreciated over time. This distinction has significant implications for a taxpayer's current and future tax obligations.
- Adherence to the TPRs offers numerous benefits, most notably the potential for immediate tax savings through various provisions, such as the repair and maintenance safe harbor election.
- This safe harbor allows certain routine maintenance costs to be expensed immediately, providing a direct reduction in taxable income in the year the expenses are incurred. Furthermore, by correctly classifying expenditures, businesses can ensure they are appropriately claiming deductions for depreciation on capital assets according to the prescribed schedules. This accurate depreciation method allows for the recovery of an asset's cost over its useful life, contributing to long-term tax benefits.
- **Conversely, failing to comply with the Tangible Property Regulations can lead to severe financial repercussions.**
    - The Internal Revenue Service (IRS) actively enforces these regulations, and non-compliance can result in the disallowance of depreciation deductions, not only for the current tax year but also retroactively to previous years.
    - This retroactive disallowance can trigger significant adjustments to past tax liabilities, potentially leading to substantial back taxes owed.
    - Additionally, the IRS may impose penalties and charge interest on any underpaid taxes resulting from incorrect classifications. These penalties and interest charges can compound the financial burden of non-compliance.
- Correcting instances of non-compliance can be a complex and time-consuming process. Taxpayers may be required to file IRS Form 3115, Application for Change in Accounting Method, to rectify any misclassifications of tangible property expenses.

Why the TPR Regulations Were Created

To improve clarity and consistency, the Treasury Department and the IRS issued TPRs..

1. These regulations represent a significant effort to consolidate decades of evolving case law, administrative pronouncements, and industry best practices into a more coherent and structured framework.
2. The primary objective of these regulations is to provide taxpayers with more precise guidance on whether specific costs incurred for tangible property should be treated as deductible repairs or as capital improvements.
3. By establishing a more definitive set of rules and principles, the regulations aim to reduce ambiguity, minimize disputes, and promote greater consistency in tax reporting.

The TPRs introduce several key provisions and elective simplifying methods that taxpayers can prospectively adopt. These include:

1. The De Minimis Safe Harbor (DMSH) allows businesses to deduct certain low-value asset acquisitions and improvements immediately.
2. The Safe Harbor for Small Taxpayers (STSH) provides a simplified method for small businesses to deduct specific repair and maintenance costs.
3. Additionally, the regulations offer an election to capitalize repair and maintenance costs based on a taxpayer's book records, providing an alternative approach that may align more closely with financial accounting practices.

Before the issuance of these final regulations on September 17, 2013, through Treasury Decision 9636, both the IRS and taxpayers were largely reliant on a patchwork of often inconsistent case law and administrative rulings to navigate the intricacies of repair versus capitalization decisions.

This reliance on precedent usually led to uncertainty and made it challenging for taxpayers to confidently determine the appropriate tax treatment for their tangible property expenditures. The lack of a unified and comprehensive set of rules created an environment ripe for disagreements and potential litigation.

The implementation of the Tangible Property Regulations marks a significant step towards providing taxpayers with a more predictable and structured approach to determining the correct tax treatment of tangible property expenses.

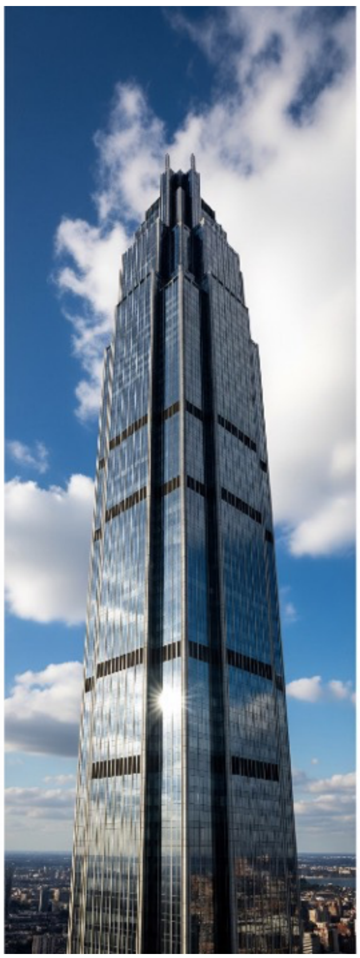
By offering more precise definitions, specific rules, and elective safe harbors, these regulations empower taxpayers to make more informed decisions, reduce the burden of subjective interpretations, and ultimately foster greater compliance with tax law.

While applying these regulations still requires careful consideration of specific facts and circumstances, they undoubtedly provide a more robust and reliable framework compared to the previously less specific tax environment.

Critical Concepts: Unit of Property

The Unit of Property (UOP) is a fundamental concept in the IRS Tangible Property Regulations (TPRs) for deciding whether costs related to physical assets should be capitalized or expensed.

- A UOP is defined as a distinct asset where all components are functionally interdependent, working together for a specific purpose. Identifying the UOP is essential because it sets the boundaries for determining if an expenditure is a deductible repair or a capitalizable improvement under the TPRs.
- For non-building systems, functional interdependence defines a UOP; placing one component into service relies on the other components.



- For example, in a machine, all parts that operate together for a specific function form a single unit operation (UOP).
- Once a UOP is established, evaluating expenditures involves determining if they constitute a betterment, restoration, or adaptation.
- Betterment addresses a material defect, adds a significant component, or enhances productivity or efficiency.
- Restoration returns a property to its usual operating condition after substantial deterioration.
- Adaptation modifies a property for a new use that is inconsistent with its original purpose.

- [x] **Expenditures that improve a UOP (betterment, restoration, or adaptation) must be capitalized and depreciated.**
- [x] **Conversely, repairs and maintenance that do not improve the UOP can typically be expensed in the current tax year.**

In essence, the UOP concept assists businesses and taxpayers in:

- defining the correct scope for evaluating tangible property expenditures;
- differentiating between deductible repairs and capitalizable improvements;
- and ensuring the correct tax treatment of tangible property costs per the TPRs.

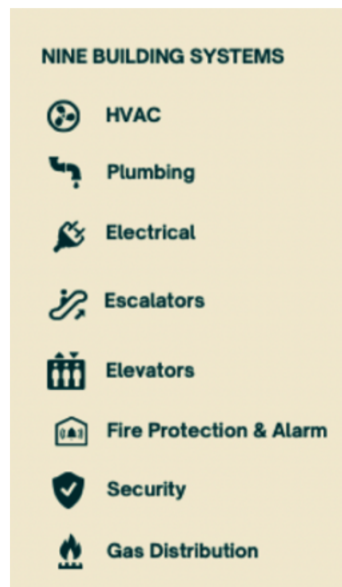
Building Systems:

Categorize buildings once the Unit of Property (UOP) has been determined.

Each system must be accounted for separately within the property.

- Understanding each building system's value helps owners make informed capital vs. expense decisions, optimizing taxes and compliance.
- Categorizing systems beyond the Unit of Property (UOP) is crucial for financial management and efficiency.
- After defining the UOP, breaking down a building into its systems allows for a more precise understanding of its value and lifecycle.

These nine broad building systems are commonly identified to provide a framework for managing a property's complex infrastructure.



1. **Heating, Ventilation, and Air Conditioning (HVAC):** This system is crucial for maintaining a comfortable and healthy indoor environment. It encompasses boilers, chillers, air handling units, ductwork, and control systems. Its operational efficiency and maintenance directly impact energy consumption and occupant well-being.
2. **Plumbing:** This encompasses the intricate network of pipes, fixtures, and equipment for water supply and waste disposal. Proper functioning of the plumbing system is essential for sanitation and daily operations.
3. **Electrical:** This system distributes power throughout the building, including wiring, lighting fixtures, panels, generators, and transformers. Its reliability is critical for all building functions, from basic lighting to complex machinery.
4. **Fire Protection:** This vital system is designed to detect, suppress, and contain fires, including sprinklers, alarms, smoke detectors, and fire extinguishers. Compliance with fire safety regulations is crucial for ensuring occupant safety and preserving property.
5. **Security:** This system aims to protect the building and its occupants from unauthorized access and threats, incorporating elements like access control systems, surveillance cameras, and alarm systems.
6. **Elevators and Escalators:** In multi-story buildings, these systems provide essential vertical transportation for occupants and goods, requiring regular maintenance and modernization.
7. **Landscaping: Although** often considered an exterior feature, landscaping can be a significant asset that contributes to a property's value and appeal. It involves irrigation systems, plantings, and hardscaping.
8. **Site Improvements:** This category includes external infrastructure directly related to the building, such as parking lots, sidewalks, and drainage systems.
9. **Other Specialized Systems:** Depending on the building's use, different systems may exist, such as specialized equipment in a manufacturing facility or medical equipment in a hospital.

- To simplify compliance, the regulations include several optional provisions that can be implemented going forward.

Safe Harbors

Three safe harbors permit expensing certain small expenditures without examination as an administrative convenience, reflecting that the law is not concerned with trivial amounts.

- The TPR regulations integrate extensive case law and other relevant guidance to provide a more transparent structure for making these determinations.
- These are the De Minimis Safe Harbor (DMSH), the Safe Harbor for Small Taxpayers (STSH), and the option to capitalize repair and maintenance expenses according to a company's financial records.
- Before the IRS issued final regulations on September 17, 2013 (Treasury Decision 9636), the distinction between repair and capitalization expenses lacked clear guidelines, leading to reliance on conflicting case law and IRS rulings.
- These new regulations now provide taxpayers with a more consistent and organized framework for determining the proper treatment of costs associated with tangible property.

TPRs are beneficial for those with high renovation or repair costs.

Minimized Audit Risk
.Accurate Transfer Pricing Regulation (TPR) compliance and clear records reduce the risk of IRS audits and penalties, allowing businesses to focus on growth.

TPRs offer significant tax benefits and simplify compliance through 3 key provisions:

1. De Minimis Safe Harbor (DMSH): Businesses meeting specific invoice criteria can instantly write off the expense of items costing $2,500 or less.

2. Small Taxpayer Safe Harbor (STSH):
Small businesses are eligible to deduct business expenses related to building improvements, with a maximum annual deduction of $10,000 or 2% of the building's adjusted basis, whichever is less.

3. Routine Maintenance Safe Harbor (RMSH):
Businesses can immediately deduct recurring building maintenance expenses if those expenses are expected to occur within the next 10 years. This provision permits the immediate expensing of these maintenance costs.

De Minimus Safe Harbor

By diligently managing purchase transactions and invoicing practices, taxpayers can strategically leverage the De Minimis Safe Harbor to achieve valuable tax savings and administrative simplification for their smaller capital expenditures.

- Understanding the nuances of this provision, including the annual election requirement, the per-item cost limitation, and the exceptions for bundled costs and larger projects, is paramount to effectively utilizing its benefits.

- The De Minimis Safe Harbor (DMSH) enables you to treat smaller capital expenditures, specifically those under $2,500 per item, as current-year expenses rather than adhering to the more complex and time-consuming capitalization rules. This election offers immediate tax relief and simplifies record-keeping for qualifying purchases.

- The term "de minimis," originating from Latin and translating to "minimal things," aptly describes the nature of the expenditures eligible for this safe harbor.

- The IRS established this threshold to alleviate the administrative burden associated with capitalizing and depreciating numerous low-cost assets.

- It is crucial to understand that the De Minimis Safe Harbor is not an automatic application but rather an annual election that the taxpayer must affirmatively make each tax year. This election is made by attaching a statement to the taxpayer's timely filed tax return, including extensions. The specific details required in this statement are outlined in IRS guidance.

To qualify for the DMSH, several conditions must be met.

1. The expenditure must be for tangible property.
2. The cost of each item or invoice must not exceed $2,500. This threshold applies per item, even if multiple items are acquired simultaneously.

A common point of confusion arises when considering bundled purchases or additional costs associated with an asset. For instance, while a computer priced at $2,400 would qualify under the DMSH, if related expenses such as shipping and installation collectively push the total cost above $2,500, the entire expenditure becomes ineligible for the safe harbor.

This necessitates careful attention to invoicing and cost allocation.

Small Taxpayer Safe Harbor

The Small Taxpayer Safe Harbor presents a considerable tax advantage for smaller businesses undertaking building improvements.

By allowing the immediate expensing of these costs, within defined limits, the STSH can lead to reduced tax liabilities and simplified tax compliance.

To use the small taxpayer simplified housing (STSH) safe harbor, an eligible taxpayer must annually elect to do so.

- Eligibility is for those with average annual gross receipts of $10 million or less over the past three tax years. Exceeding this amount in any year disqualifies the taxpayer for the current year.

- STSH regulations limit expensed building improvements to the lesser of 2% of the building's unadjusted basis (original cost excluding land) or $10,000 annually.

- When using both STSH and De Minimis Safe Harbor (DMSH), which allows immediate expensing of low-value property, all DMSH expenses for building improvements must be combined with other improvement costs and remain within the STSH limits.

- This prevents exceeding STSH limitations when utilizing both safe harbors.

Businesses wanting to take advantage of this provision must consistently oversee their average gross receipts to maintain eligibility and meticulously record all expenses related to buildings, including those under the De Minimis Safe Harbor, to stay within set limits.

It is also essential to understand specific exclusions, such as land improvements, for the correct application of the STSH.

Therefore, diligent planning and record-keeping are essential for small businesses to effectively utilize the Small Taxpayer Safe Harbor.

Routine Maintenance Safe Harbor

The Routine Maintenance Safe Harbor (RMSH) allows taxpayers to expense routine asset upkeep costs without annual elections. It applies automatically to qualifying expenditures reasonably expected to occur more than once within ten years to maintain an asset's efficient operation.

Examples include regular HVAC servicing, roof patching, minor plumbing and electrical repairs, painting, and cleaning. These deductible expenses preserve existing functionality and prevent deterioration, unlike capitalizable improvements.

It is crucial to distinguish routine maintenance from capital improvements. The RMSH explicitly states that expenditures that improve an asset, enlarge its capacity, or materially increase its efficiency do not qualify for the safe harbor. Such expenditures are generally required to be capitalized and depreciated over the useful life of the asset.

Determining whether an expenditure constitutes routine maintenance or a capital improvement often requires careful consideration of the nature of the work performed, its impact on the asset, and the taxpayer's intent. For instance, replacing a small section of damaged roofing would likely be routine maintenance, while completely replacing the entire roof would likely be classified as a capital improvement.

- The classification requires careful consideration of the work's nature, its impact on assets, and the taxpayer's intent.

Examples:

1. Small roof section replacement is routine maintenance; complete roof replacement is a capital improvement.

2. Repairing a single component of an HVAC system might qualify as routine maintenance, whereas installing a completely new, more efficient HVAC system would likely be a capital expenditure. Routine maintenance differs from capital improvements.

The Routine Maintenance Safe Harbor (RMSH) provides substantial tax benefits for businesses with recurring maintenance requirements. By expensing these costs, taxpayers achieve immediate tax savings and improved cash flow compared to capitalizing and depreciating them over time. The RMSH provides a more advantageous tax treatment for many maintenance expenses.

RABI Rules

R estoration

A daptation

B etterment

I mprovement

When Safe Harbors do not apply, taxpayers must consider the RABI rules. To determine whether an expenditure must be capitalized or can be expensed.

Restoration (R in RABI):
Expenditures within two years of occupancy or for components in total disrepair must be capitalized as a restoration.

- This capitalization rule prevents the immediate expensing of significant repairs or replacements that restore the asset to its previous condition.

Adaptation (A in RABI):
Expenditures that alter an asset's intended use must be capitalized.

- Capitalization is also required for any component adaptation resulting in a new or different use than initially planned.

Betterment (B in RABI):
Expenditures that increase a component's efficiency by over 10%, significantly enlarge it, or substantially increase its value must be capitalized.

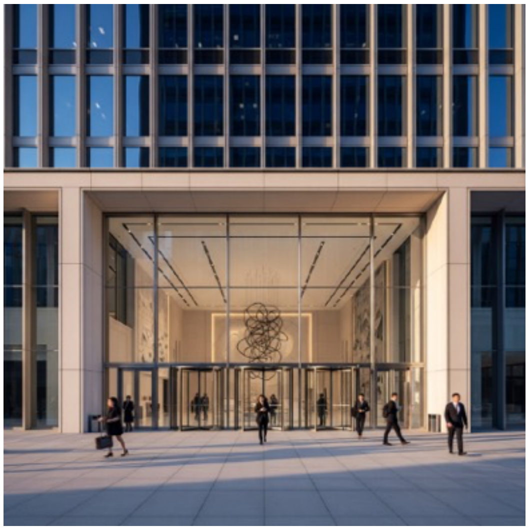
- This capitalization rule applies to betterments that enhance an asset beyond its original state.

Improvement (I in RABI):
Expenditures must be capitalized when they affect more than 33% of an asset's like components.

- This capitalization rule applies to significant improvements impacting a substantial portion of an asset, ensuring they are not expensed.

- Expenditures that repair a component to its normal daily operating condition can typically be expensed if the property has been occupied for over two years. This guideline helps you comply with IRS regulations and increase tax advantages.
- As with all IRS codes, compliance is vital and not optional. The IRS requires an annual TPR review of Depreciation Schedules to eliminate improperly capitalized items.

Opportunities UNDER § 481



- Businesses can now deduct previously capitalized repair expenses, provided these repairs meet the requirements of the current Tangible Property Regulations (TPR).

- Taxpayers must follow the TPR when deciding to expense or capitalize tangible property expenditures.

- Internal Revenue Code Section 481(a) allows taxpayers to review and revise their depreciation schedules to align with the current TPR, providing a mechanism to correct prior accounting methods for tangible property.

Initially, the IRS indicated that failing to update depreciation schedules could lead to the denial of future depreciation deductions, a concern primarily for businesses with average annual gross receipts (AAGR) over $10 million, who are expected to update their schedules proactively.

For smaller businesses (under $10 million AAGR), adjusting depreciation schedules using a Section 481(a) adjustment is optional. As long as their AAGR remains below $10 million, the IRS will not disallow future depreciation even if no adjustment is made.

- Eligibility for a Section 481(a) adjustment under Section 263(a) depends on the consistent application of the Restoration, Adaptation, Betterment, and Improvement (RBI) rules since 2015. Inconsistent prior application of these rules may limit the ability to make this adjustment.
- Businesses that have consistently used IRS safe harbor methods (DMSH, STSH, RMSH) for expense versus capitalization decisions are still eligible to use a Section 481(a) adjustment, which could lead to increased tax savings by deducting previously capitalized costs.

The current TPR makes it advantageous for businesses to realize significant tax savings by offering updated guidelines for distinguishing between deductible repairs and capitalizable improvements.

Understanding and correctly applying these regulations is crucial for optimizing a business's tax position.

Businesses should review their past practices and current regulations to determine if a Section 481(a) adjustment is beneficial and if previously capitalized repairs qualify for an immediate deduction under the Taxpayer Relief Act of 1997 (TPR).

Consulting a tax advisor is recommended to navigate these regulations, ensure compliance, and maximize potential tax savings.

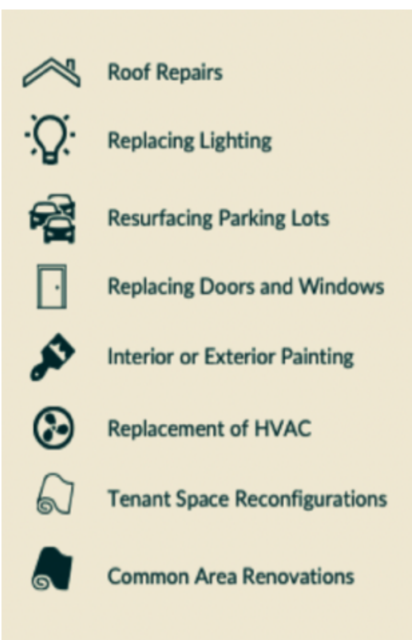
Partial Asset Disposition

A partial asset disposition (PAD) allows commercial property owners renovating their properties to recognize an immediate tax loss for the undepreciated basis and removal costs of disposed assets. This reduces their current year taxable income.

Failing to identify and document the remaining basis of disposed assets in the tax year a renovation is completed results in permanent forfeiture of the Partial Asset Disposition (PAD) tax benefit.

- This is a time-sensitive opportunity with no provision for claiming the deduction later, making meticulous record-keeping and timely action critical.

Implementing a partial asset disposition (PAD) offers more than just an immediate tax deduction.



By accounting for disposed assets through a PAD, property owners can maintain accurate depreciation schedules reflecting only the assets currently in service.

- This eliminates outdated or duplicate assets from the schedule, simplifying tax compliance and preventing potential issues like the recapture of excess depreciation when the property is sold.
- This accurate long-term depreciation management is a key secondary benefit of utilizing PADs.

Recapture occurs when the sale price exceeds the adjusted basis due to previously claimed depreciation deductions.

By correctly removing disposed assets from the depreciation schedule via a PAD, the potential for unexpected tax liabilities from depreciation recapture upon sale is significantly reduced.

In summary, a PAD provides both an immediate tax benefit through a current-year deduction and a future benefit by ensuring accurate depreciation records and mitigating potential depreciation recapture upon the sale of the commercial property.

Resolution

The IRS Tangible Property Regulations (TPRs) are intricate, carrying both tax advantages and risks. Following these rules enables the immediate deduction of certain expenses, resulting in substantial tax savings. However, failure to comply can result in penalties, including disallowed deductions and back taxes with interest.

☑ **To ensure TPR compliance and optimize deductions before a Cost Segregation Study, it's crucial to correctly expense all eligible assets under Section 263(a).**

Our team's specialized expertise helps identify prior expenditures for potential capitalization or expensing. They also provide guidance on building renovations and repairs, aiming to expense costs whenever possible to reduce current tax obligations and potentially minimize future capital gains tax.

The IRS Tangible Property Regulations (TPRs) are a complex and strictly enforced system for managing costs related to tangible property.

Businesses following the TPRs can achieve substantial tax savings by correctly expensing eligible asset costs, thus lowering their immediate tax liability. However, failure to comply can result in disallowed deductions, back taxes, and interest charges.

- Accurate expensing of qualifying asset-related costs under IRC Section 263(a) is a critical preliminary step before conducting a cost segregation Study, a tax strategy for accelerating depreciation.
- Correctly treating these expenditures maximizes the benefits of the Cost Segregation study and ensures compliance with the Tangible Property Regulations (TPRs). Proper initial expensing has a significant impact on the effectiveness of the cost segregation analysis.

Our Team's offers extensive experience and specialized knowledge in navigating the complexities of TPRs. We assist taxpayers in reviewing past expenditures to determine the appropriate tax treatment (capitalization or immediate expensing) according to current regulations.

Additionally, we provide proactive expert guidance on building renovations and repairs, ensuring eligible costs are expensed to reduce current tax liabilities. Strategically expensing these costs can also minimize long-term capital gains tax liability upon the disposition of the property.

Our team's deep understanding of TPRs and their practical application makes us a valuable partner for optimizing tax positions and reducing non-compliance risks.

IRS Consequences if You are Non-Compliant with TPR

Non-compliance with the IRS TPR can lead to a range of significant financial and operational problems for businesses and individuals.

In-Depth Look at Financial Repercussions:

- Non-compliance with TPR incurs significant IRS penalties on underpaid taxes, plus interest. Retroactive assessments can lead to unexpected financial burdens, impacting cash flow, long-term stability, operational effectiveness, and public image.
- TPR non-compliance can result in the loss of depreciation deductions, leading to increased taxable income and tax liability, which can adversely affect past performance, future projections, and deter capital investments.
- TPR non-compliance results in lost tax savings and reduced profitability. Incorrect expense classification leads to missed deductions, higher taxes, and hindered cash flow, ultimately impacting financial success.

Risks Associated with Non-Compliance:

Increased IRS Audit Risk: Non-compliance with TPR signals the IRS, raising the risk of an in-depth audit that strains resources and staff. Audits involve financial reviews, interviews, and workflow disruptions, resulting in direct costs (such as accounting and legal fees) and indirect costs (including management time and business interruptions).
They may uncover further non-compliance, which could result in harsher penalties and increased scrutiny. Overall, non-compliance increases the risk of resource-intensive audits, resulting in substantial costs from operational disruptions and potential additional penalties.

Legal Consequences and Damage to Reputation:

Ignoring IRS law offers no defense in tax disputes and can lead to severe financial penalties for companies and their stakeholders. Investors may face further legal action due to such losses. Public awareness of non-compliance can damage a company's reputation, erode trust, and harm relationships.

How Serious Is the IRS About TPR Compliance? See for yourself

7-Step Guide to Benefits of TPR Compliance

1. **Analyzing and Categorizing Property Costs:** Scrutinize all expenses for acquiring, producing, or enhancing tangible property. Organize these costs into categories based on **the** Tangible Property Regulations (TPR), with a focus on distinguishing between repairs and improvements.
2. **Strategic Use of Safe Harbors:** To maximize potential deductions, leverage the following safe harbor provisions:
   - **De Minimis Safe Harbor (DMSH):** For purchases costing $2,500 or less.
   - **Small Taxpayer Safe Harbor (STSH):** For qualifying costs associated with eligible buildings.
   - **Routine Maintenance Safe Harbor (RMSH):** For maintenance activities that meet the specified criteria.
3. **Defining Property Units and Building Systems:** To accurately apply repair and improvement rules, delineate properties into distinct units and identify separate building systems, such as HVAC and plumbing.
4. **RABI Analysis for Non-Safe Harbor Costs:** For costs that do not qualify for safe harbor treatment, employ the RABI (Restoration, Adaptation, Betterment, Improvement) analysis. Capitalize costs classified as improvements and deduct those identified as eligible repairs.
5. **Leveraging Section 481(a) Adjustments:** Ensure compliance with TPR by aligning previous accounting methods. File IRS Form 3115 to reclassify previously capitalized expenses as currently deductible.

6. **Claiming Partial Asset Dispositions (PAD):** When renovations involve replacing existing assets, identify these replacements and write off any remaining depreciable basis. Claim PADs in the year the replacement occurs to avoid losing the deduction.
7. **Maintaining Comprehensive Records:** Preserve all relevant documentation for all property-related expenses, including invoices and receipts. Additionally, keep thorough records substantiating the use of any safe harbor provisions.
   - Elections and Section 481(a) adjustments.

Six issues lead to a Taxpayer-Favorable 481(a) Adjustment

1. Bonus depreciation is taken incorrectly.
2. Improper depreciable lives
3. Depreciation taken or not taken on assets not owned
4. Routine maintenance of the safe harbor
5. Prior capitalization of items that the clients did not need to capitalize (in light of the new TPRs)
6. Partial building dispositions

Improve Profit With A 481(A) Adjustment

Below is an explanation of the six Issues from the previous page

1. **Bonus Depreciation Taken Incorrectly:**
    - Instances where bonus depreciation was either incorrectly claimed or not claimed when it was applicable.
2. **Improper Depreciable Lives:**
    - Incorrect assignment of depreciable lives to assets has led to over- or under-depreciation.
3. **Depreciation Taken or Not Taken on Assets Not Owned:**
    - Tax fraud can involve either fraudulently claiming depreciation on assets not owned by the client or fraudulently omitting depreciation claims on assets owned by the client.
4. **Routine Maintenance Safe Harbor:**
    - Unnecessary expense capitalization occurred due to the failure to utilize the routine maintenance safe harbor when applicable.
5. **Prior Capitalization of Items that the Clients Did Not Need to Capitalize:**
    - Certain situations exist where items previously capitalized under prior regulations can be expensed under the current Tangible Property Regulations (TPRs).
6. **Partial Building Dispositions:**
    - When a part of a building is sold or otherwise disposed of, the related depreciation should be adjusted. This issue arises when such adjustments are not made.

Noncompliance may require taxpayers to file IRS Form 3115 for accounting method adjustments, a complex and lengthy process that underscores the value of proactive compliance. Thorough compliance with the Tangible Property Regulations (TPRs) enables businesses and real estate owners to classify property expenses accurately, potentially increasing tax savings and preventing expensive IRS penalties.

Section 3 - Detailed Discussion of 6 Key Concepts

Unit of Property

Capitalization Requirements:

Taxpayers are required to capitalize costs associated with acquiring or producing a unit of real or personal property. This includes:

- Leasehold improvements
- Land and land improvements
- Machinery and equipment
- Furniture and fixtures

Definition of a Unit of Property:

A Unit of Property comprises all functionally interdependent components of a property. Components are considered functionally interdependent when the operation of one depends on the operation of others.

Separate Units of Property:

Components are also treated as distinct Units of Property if they are depreciated under different Modified Accelerated Cost Recovery System (MACRS) property classes (e.g., 5, 7, and 15-year MACRS properties).

Capitalization vs. Repair Expenses:

Costs incurred to acquire or improve a Unit of Property generally must be capitalized and depreciated, unless they qualify as deductible repair expenses. The final regulations permit the current-year expensing of repair costs unrelated to substantial rehabilitations or improvements. This contrasts with the previous rule, which required capitalization of repair expenses if they were part of a larger rehabilitation or improvement project.

Other Expense Deductions:

Amounts paid may also be expensed under the "materials and supplies rule" or specific safe harbor provisions outlined in the regulations.

Retirement and Replacement of Components:

The final regulations permit taxpayers to recognize a loss on retired or replaced components, rather than continuing depreciation. Additionally, the costs associated with removing such elements can be deducted in the year of retirement or replacement. Previously, these "removal costs" were required to be capitalized as part of the cost of the new replacement component.

Unit of Property (UOP) Rules:

Special rules apply to plant property, leased property, and buildings for determining the Unit of Property.

- **Plant Property:** A UOP is a component that performs a discrete and major function within functionally interdependent equipment. Functionally interdependent equipment can have multiple separate units of production (UOPs), such as an assembly line.

- **Leased Property:**
  - **Lessor:** The entire building is the UOP.
  - **Lessee:** The UOP is the portion of the building leased.
  - **Example:** A lessee remodeling a bathroom may have a capital improvement if it affects a significant portion of their office's plumbing. The same work by the lessor might be a repair expense if it's a small part of the entire building's plumbing. This illustrates how the same expenditure can be capitalized or expensed based on the UOP's size and a materiality threshold.

- **Buildings:** Commercial buildings are a single unit of operation (UOP). However, capitalization rules are applied separately to the building structure and its defined systems.
  - The building structure includes exterior walls, roof, windows, and doors.
  - Defined building systems are treated separately for capitalization.

- **Loss on Component Retirement:** Taxpayers can now claim a loss when components are retired or replaced instead of continuing to depreciate them. Removal costs for these retired or replaced components can also be deducted. Previously, removal costs were capitalized as part of the new component's cost.

- **Old Rule vs. New Rule:** The new regulations allow for current expensing of repair costs, even if part of a larger project, as long as they qualify under the "materials and supplies rule" or safe harbors. The old rule required capitalizing repair expenses if done during a larger rehabilitation or improvement project. Under the new rule, instead of continuing to depreciate a replaced structural component and simultaneously depreciating the latest improvement, the retirement of a structural element can be considered a disposition, and a loss can be recognized.

Acquisition Costs

Acquisition costs must be capitalized, which are the initial payments for tangible property forming a UOP (including all its components). These capitalized expenditures are recovered through depreciation or when the property is disposed of. Transaction or facilitative costs associated with acquisition costs must also be capitalized, regardless of whether the work occurs before or after the asset is placed in service.

Facilitative costs include expenses incurred while investigating or pursuing an acquisition, such as:

1. Transportation or shipping fees
2. Appraisals
3. Negotiating terms and obtaining tax advice
4. Application fees, bidding expenses, or similar costs

5. Preparing and reviewing documents like sales contracts or purchase agreements
6. Examining and evaluating the title
7. Obtaining regulatory approval or permits, including application fees
8. Brokers' commissions, finders' fees
9. Architectural, geological engineering, and environmental inspections
10. Services provided by a qualified intermediary or facilitator

Facilitative costs can be allocated between acquired and non-acquired property, but contingency fees must be entirely allocated to the acquired property.

Generally, employee compensation and overhead do not facilitate the acquisition of real or personal property and are therefore not required to be capitalized when determining a UOP's acquisition cost. However, taxpayers can choose to capitalize employee compensation, overhead expenses, or both as costs that facilitate property acquisition.

Improvements

Taxpayers are required to capitalize costs associated with improving a Unit of Property (UOP) that they own, in addition to the initial acquisition costs. An "Improvement" is defined as any cost incurred after the UOP is placed in service and falls into one of three categories:

- **Betterments:** Expenditures that enhance the condition or value of the UOP.
- **Adaptations:** Costs that change the UOP to a new or different use.
- **Restorations:** Expenses that return the UOP to its original state after deterioration or damage.

While improvements must be capitalized, ordinary repairs are deductible. The key distinction lies in the degree of improvement. Permanent improvements that increase a property's value or extend its useful life are generally capitalizable.

Whether an expenditure qualifies as an improvement often depends on its materiality relative to the UOP's cost basis. The IRS suggests a guideline of around 30%. Notably, the size of the UOP has a significant influence on this determination. Costs associated with smaller UOPs are more likely to be classified as capitalizable improvements. For instance, a $15,000 expenditure on a UOP with a $35,000 cost basis would likely be an improvement. Conversely, the same $15,000 expenditure on a UOP with a $350,000 cost basis might be treated as a deductible repair. Consequently, each cost must be evaluated in the context of the specific UOP to which it relates.

A betterment, which must be capitalized, occurs when a capital expenditure materially improves a unit of property (UOP) through one of the following:

- **Correction of a Significant Pre-existing Defect:** This addresses the property's condition at the time of acquisition, such as an immediate roof replacement on a newly purchased building or remediation of contamination present before land purchase. However, asbestos removal is not considered a betterment. This does not include improvements related to business renovation decisions.

- **Addition of a Major Component or Physical Expansion:** This involves adding a substantial part to the UOP or increasing its size, scope, or reach.
- **Reasonable Increase in Functionality:** This enhances the UOP's strength, productivity, efficiency, quality, or output.

For instance, replacing asphalt shingles with solar shingles is an improvement that requires capitalization. In this case, the old shingles can be retired, allowing for a recognized loss (adjusted basis less salvage value), and the removal costs of the old shingles are deductible. Conversely, replacing unavailable wooden shingles with comparable, slightly stronger asphalt shingles is not a betterment and may be treated as a repair expense. Similarly, enhancements due to technological advancements, such as replacing old HVAC equipment with more efficient new HVAC equipment, are not necessarily betterments.

An **adaptation** requires capitalization and happens when a cost is incurred to change a UOP to a use different from its original intended purpose when it was first placed in service. For example, converting a manufacturing building into a showroom by altering its structural components for a better layout is an adaptation.

A **restoration** involves replacing a component of a UOP, which may allow the taxpayer to claim a partial disposition or a casualty loss for the replaced component or recognize a gain or loss from its sale.

Restoration involves returning a unit of property (UOP) to its normal, efficient operational state if it has fallen into disrepair and is no longer functional. This includes rebuilding a UOP to a like-new condition after its class life ends, or replacing a major component (or a significant portion thereof) or a substantial structural part.

Determining if an action is a restoration requires considering all relevant quantitative and qualitative factors, not solely cost, size, type, or function. The process involves first identifying the primary component of a building system and then assessing if a significant portion was replaced. Replacing a minor component, even if it affects the UOP's function, does not constitute a significant component or material structural part.

If a significant component is not replaced, the cost may be a repair, but this is not always the case. The IRS indicates that materiality thresholds are generally around 30%, with some flexibility.

Capitalization vs. Repair Expenses: Examples
Restoration (Capitalized):

- **Significant Structural Damage:** Replacing a substantial portion of a roof's decking and rafters due to rot, along with a part of the roof itself, is considered a restoration.
- **Replacement of a Critical Component:** In an HVAC system with a cooling tower, boiler, and chiller, replacing the chiller (which performs a discrete and critical cooling function) is a restoration.

Repair Expenses (Not Capitalized):

- **Minor Roof Work:** Replacing roof tiles or a roof membrane with a comparable new one is generally considered a repair.

Replacement of a Non-Significant HVAC Component: If an HVAC system has multiple similar units (e.g., 3 furnaces) and only one needs replacement, it's likely a repair expense, provided it doesn't exceed a materiality threshold (e.g., 30%). This is because the replaced unit isn't considered a significant portion of the overall system or a restoration of its functionality.

Sale or Exchange of Replaced Components

A gain or loss may be recognized in the current tax year from selling or exchanging a major replaced component. This represents the difference between the component's adjusted basis at the time of replacement and the sale or exchange proceeds. Costs associated with removing the replaced component are deductible. However, a loss cannot be deducted if a retired component's only remaining value is salvage (i.e., fully depreciated).

Casualty Loss and Restoration

If a casualty loss is deducted for damaged property, the subsequent costs to restore the property to its efficient operating condition are generally capitalized. The capitalized amount is limited to the restoration cost minus the previously claimed casualty loss, which itself cannot exceed the adjusted basis of the damaged component. Restoration costs can be treated as repairs if the basis of the damaged component is adjusted.

Book Capitalization Election for Repairs and Maintenance

Typically, routine repair and maintenance costs that maintain a property's efficient operation are deductible as ordinary business expenses. However, taxpayers can elect to capitalize these costs as improvements if they are also capitalized for book purposes. This annual election is irrevocable for that year. It is made by attaching a statement to the timely filed tax return (including extensions) for the year the costs were paid or incurred, starting on or after January 1, 2014. Form 3115 is not required for this annual election. Early adoption was permitted for costs in 2012 and 2013 via Form 3115, provided the accounting methods for those years already complied with the final regulations.

Incidental Materials and Supplies: The cost of incidental materials and supplies (e.g., fuel, lubricants, water expected to be consumed within 12 months) is deductible when paid or incurred. Taxpayers not following this accounting method before January 1, 2014, must file Form 3115 to change their accounting method.

Non-Incidental Materials and Supplies:

- Those for which inventory records are maintained are deductible when used or consumed in the taxpayer's operations (removed from inventory and placed in service).
- Those used as part of a capital project, rather than routine repair or maintenance, generally must be capitalized and depreciated.
- Taxpayers who did not follow these rules for non-incidental materials and supplies before January 1, 2014, must file Form 3115 to change their accounting method.

Taxpayers may need to make Section 481 adjustments for non-compliance with the rules for both incidental and non-incidental materials and supplies.

Businesses can immediately deduct the cost of materials and supplies costing $200 or less, or those with a useful life of one year or less, if they are used in business operations and not acquired together as a single unit of property (UOP). This applies to costs for acquiring, maintaining, repairing, or improving owned or leased UOPs, including routine spare parts and both incidental and non-incidental items under $200.

While businesses might capitalize and depreciate property units costing $200 or less for bookkeeping, this is not allowed for tax purposes; these items must be expensed. This creates a potential book-tax difference that needs to be tracked.

Compliance with these regulations requires filing Form 3115, "Application for Change in Accounting Method," as this rule is mandatory. However, the accounting method change is applied prospectively, meaning no Section 481 adjustments are necessary.

Temporary regulations allowed a deduction of materials and supplies costing $100 or less, with an option to capitalize. Final regulations eliminated the capitalization election for incidental and non-incidental materials and supplies, restricting it to rotatable, temporary, or standby emergency spare parts. The final rules also increased the threshold for capitalization-exempt property from $100 to $200, with the possibility of further increases via IRS guidance.

Rotable and temporary spare parts are treated differently from routine, expendable ones. Generally, non-incidental rotable and temporary spare parts under the final regulations are neither deductible nor depreciable until permanent disposal, requiring an accounting method change via Form 3115 and potential Sec. 481 adjustments for prior non-compliance. However, taxpayers can elect to capitalize and depreciate these parts. This election, made by taking a position on the tax return in the acquisition year without a separate statement, is not considered a change in accounting method and does not require Form 3115.

Taxpayers can choose to capitalize and depreciate some spare parts while expensing others. However, this election is irrevocable.

Once a rotable or temporary spare part is capitalized, its entire cost is generally recovered only upon permanent disposal (sale, scrapping, etc.). Due to their less frequent use, rotables may last longer, extending their depreciation period. Consequently, depreciating the entire cost of such parts under this election can take significantly longer.

Taxpayers can also opt for an alternative accounting method for rotable and temporary spare parts. To initiate this change, taxpayers must file Form 3115.

Taxpayers have an "optional method" for deducting the full cost of new rotable or temporary spare parts in the year they are installed. When such a part is later removed, its fair market value (FMV) is reported as income in the year it is removed. The FMV, plus the costs of removal and refurbishment, becomes the part's capitalized basis. Subsequently, when the part is reinstalled, its basis and reinstallation costs are deducted in the year of reinstallation. Simultaneously, the FMV of the part removed from service at that time is included in income. This cycle of removal, income recognition, refurbishment, basis adjustment, reinstallation, and deduction continues until the rotable part is disposed of, at this point, any remaining basis is deducted.

Standby emergency spare parts differ from rotable and temporary spare parts. Once installed, they are intended for indefinite service rather than periodic removal and refurbishment. These parts may remain unused for extended periods before installation but become operational for the remainder of their useful life once installed. Unlike rotable and temporary spares, standby emergency spare parts follow the cost recovery rules for non-incidental spare parts; their cost is generally deductible when first used. However, taxpayers can capitalize and depreciate the cost of standby spare parts, which is the standard tax treatment.

Taxpayers electing the De Minimis safe harbor must deduct the cost of rotable, temporary, or standby emergency spare parts acquired within the year, provided these costs fall under the De Minimis ceiling ($500 or $5,000). This requirement applies universally, regardless of any election to capitalize and depreciate these parts. Costs below the threshold must be expensed in the year of acquisition. However, because most standby emergency spare parts exceed $5,000, they typically do not qualify for the De Minimis election.

De Minimis Safe Harbor Election

The De Minimis Safe Harbor offers taxpayers an ongoing, irrevocable election to expense the costs associated with tangible property immediately, provided the total amount paid for the property does not exceed a statutorily defined dollar threshold per invoice or per item. This provision simplifies tax accounting by allowing businesses to deduct relatively small expenditures for tangible assets in the same year they are incurred, rather than capitalizing these costs and depreciating them over their useful lives.

The types of property eligible for this immediate expensing include a broad range of assets such as materials, office and shop supplies, and other items expected to have a useful life of one year or less. Furthermore, the safe harbor also applies to the acquisition costs of individual components that make up a larger Unit of Property (UOP), as long as the cost of each element falls below the established dollar threshold.

The De Minimis Safe Harbor election became effective for tax years beginning on or after January 1, 2014. Recognizing the potential benefits for businesses, the Internal Revenue Service (IRS) also permitted early adoption of this safe harbor for amounts paid or incurred in tax years beginning on or after January 1, 2012. Taxpayers who wished to take advantage of the safe harbor for the 2012 and 2013 tax years but did not make the election on their original returns were required to file amended tax returns to claim these deductions retroactively.

It is important to note that making the De Minimis Safe Harbor election is not a taxpayer's accounting method change. Consequently, taxpayers are prohibited from using Form 3115, Application for Change in Accounting Method, to either make the initial election or revoke a previously made election. This also applies to taxpayers seeking to make a late election for the 2012 and 2013 tax years; they still had to file amended returns rather than Form 3115.

Once a taxpayer elects to utilize the De Minimis Safe Harbor, the safe harbor must be consistently applied to all eligible payments for tangible property that fall below the specified dollar threshold. This consistency requirement ensures that taxpayers cannot selectively apply the safe harbor to certain items while capitalizing on others that also meet the criteria. Amounts expensed under the De Minimis Safe Harbor must be deducted in the tax year in which the payment is made or the liability is incurred (for accrual basis taxpayers). These costs cannot be capitalized and subsequently depreciated over a more extended period, as this would contradict the fundamental purpose of the safe harbor, which is to provide immediate tax relief for small-value tangible property acquisitions.

An applicable audited financial statement includes:

1. Financial statements filed with the SEC (e.g., Form 10-K).
2. Certified audited financial statements used to obtain credit or financing.
3. Financial statements used to report performance and financial position to shareholders or partners.
4. Any certified audited financial statement used for a significant non-tax purpose.
5. Financial statements (excluding tax returns and SEC filings) legally required to be provided to a federal or state government body or agency (excluding the IRS).

This safe harbor simplifies accounting for low-cost items for businesses that prepare and audit financial statements for external purposes.

Entities included in a consolidated applicable financial statement are considered to have their applicable financial statement, even if they don't have a separate one.

The De Minimis safe harbor is extended to taxpayers without audited financial statements, allowing them to expense individual invoices or property items costing $500 or less. This is based on their accounting procedures at the start of the tax year, which don't need to be written down, as long as the amounts are expensed according to these procedures.

The De Minimis threshold applies either at the invoice level or, for multiple items on a single invoice, at the individual item level. The cost of property includes any additional charges like delivery or installation fees if they appear on the same invoice. If these extra costs are on a separate invoice, including them in the property's cost is optional. When multiple items on one invoice have a combined additional cost, a reasonable method must be used to allocate this cost to each item for calculating the per-item cost.

For instance, a taxpayer without an applicable financial statement buys 10 computers for $500 each, with a $200 delivery fee on the same $5,200 invoice. Allocating the delivery fee pro rata raises each computer's cost to $520, exceeding the $500 limit. Therefore, the De Minimis safe harbor election cannot be used. However, if the $200 delivery fee was on a separate invoice, the taxpayer could use the safe harbor to deduct both the computers and the delivery fee as expenses.

An anti-abuse rule prevents taxpayers from manipulating transactions to stay within the per-item limit. For example, the cost of a machine cannot be split into two separate invoices to avoid the De Minimis threshold.

The De Minimis safe harbor rule applies to all qualifying tangible property, including eligible materials and supplies like rotable, temporary, or emergency standby spare parts. This can confuse with the general rule for materials and supplies. Generally, non-incidental materials and supplies are deducted when used, while incidental materials and supplies without inventory records are deducted when paid. However, if a taxpayer elects the De Minimis safe harbor, non-incidental materials and supplies costing $200 or less are deducted upon purchase rather than when used. This election is not allowed if the taxpayer defers deducting these items until they are used for financial accounting purposes.
Furthermore, the safe harbor does not apply to materials and supplies used in manufacturing inventory if capitalization is otherwise required for inventory. It does not apply to amounts paid for land or intangible property like computer software. Unlike the materials and supplies rule, using the De Minimis safe harbor does not necessitate a change in accounting method.

Compared to the restrictions of the Section 179 deduction (taxable income requirement and deduction ceiling) and bonus depreciation (new property requirement), the de minimis safe harbor offers a more straightforward and less restrictive compliance path for some taxpayers. However, businesses can achieve maximum tax savings through careful planning that strategically combines the de minimis safe harbor, Section 179 expensing, and bonus depreciation.

The De Minimis safe harbor election is an annual, irrevocable choice that must be documented in a written policy. This policy must be included with the taxpayer's original yearly tax return, filed on time with any applicable extensions.

The written policy should specify that any amount paid for a single item of property costing less than a certain threshold ($5,001 or $501, depending on the situation) or for items with an economic useful life of 12 months or less will be expensed rather than capitalized.

Below is an example of acceptable wording for the De Minimis safe harbor election:

"ABC Company hereby elects to adopt the following policy for both book and Federal income tax purposes regarding the capitalization of expenses for the year beginning January 1, 2014. Consistent with Internal Revenue Code Sections 167 and 168 and related regulations, ABC Company has determined that individual costs (including associated tax, installation, and delivery fees) that do not exceed $500, or items with a useful life of 12 months or less, will be deducted as an operating expense. Expenditures exceeding this dollar threshold will be individually assessed under the betterment, adaptation, or restoration capitalization rules employed by the IRS to determine if capitalization or expensing is appropriate based on the application of those rules." (Note: Companies with audited financial statements should replace $500 with $5,000).

Small taxpayers with average annual gross receipts of $10 million or less for the prior three tax years can elect a safe harbor. This election allows them to deduct the total amount paid during the taxable year for improvements, repairs, maintenance, etc., performed on a building with an unadjusted basis of $1 million or less, without applying tangible property regulations. However, the deductible is limited to $10,000 or 2% of the building's unadjusted basis. This safe harbor is an all-or-nothing provision; if expenditures exceed these limits, no amount is eligible for the safe harbor. The Small Taxpayer Safe Harbor election is applicable for tax years starting on or after January 1, 2014, with early adoption available for amounts paid or incurred in tax years beginning on or after January 1, 2012. Late elections for 2012 and 2013 can be made by filing amended tax returns.

The small taxpayer safe harbor election doesn't require filing Form 3115 as it's not an accounting method. Once elected, the safe harbor must be applied to all qualifying expenses. If these expenses are ordinary and necessary business expenses, they are deducted in the year paid and cannot be capitalized. For S-corporations and partnerships, the entity, not the individual owners, makes the election annually by attaching a statement to a timely filed tax return. This election cannot be made or revoked via Form 3115.

Cost Segregation Study and Safe Harbor

A cost segregation study can help taxpayers meet the safe harbor requirements. For instance, if a taxpayer buys a building for $800,000 and later makes $300,000 in capital improvements, the $1,000,000 unadjusted basis rule would not be met. However, if a cost segregation study reclassifies 30% ($330,000) of the total basis as Section 1245 personal property, the building's basis would decrease to $770,000, thus qualifying for the safe harbor election.

A cost segregation study may identify a retired component of a unit of property (UOP). For example, if an element with an original cost of $400,000 and $100,000 of accumulated depreciation was retired in 2012, filing Form 3115 allows recognition of a $300,000 loss ($400,000 original basis less $100,000 depreciation) on the 2014 tax return. The removal cost of the retired component can also be expensed. This loss is only claimable in 2014, as it is the last year for a late partial disposition election. Without this election, the remaining $300,000 basis of the replaced component would continue to be depreciated.

However, a late partial disposition election disallows repair deductions taken for the replacement component. Conversely, if the IRS disallows a repair deduction for a replacement during an audit and requires capitalization, a taxpayer can make a late partial disposition election by filing Form 3115.

Routine Maintenance Safe Harbor

The Routine Maintenance safe harbor allows taxpayers to treat recurring payments for maintaining a unit of property (UOP) in ordinary efficient working condition as repair costs, which can be expensed immediately rather than capitalized and depreciated. This applies to activities reasonably expected to occur more than once during the property's class life, or for a building (or its structural components) within the first 10 years after being placed in service. This safe harbor applies to costs that are considered capital improvements. To determine if an expenditure qualifies, taxpayers should consider the recurring nature of the activity, industry practices, manufacturers' recommendations, and their own experience with similar property. For example, the cost to resurface a parking lot (a 15-year property) every five years can be expensed under this safe harbor. However, this safe harbor does not apply to rotable spare parts accounted for under the optional method (method 2).

The Routine Maintenance safe harbor is not an election but automatically applies if the requirements are met. Utilizing this safe harbor is considered a method of accounting and necessitates filing Form 3115, "Application for Change in Accounting Method."

Disposal of MACRS Property

A disposition of Modified Accelerated Cost Recovery System (MACRS) property, whether a Unit of Property (UOP) or a component thereof, occurs when ownership is transferred or the property is permanently withdrawn from use in a trade, business, or for income production. Examples of disposition include retirement, sale, exchange, physical abandonment, or destruction of a UOP or its component.

Generally, a disposition recognizes a gain or loss based on the remaining adjusted basis (undepreciated basis) of the disposed asset, encompassing the removal cost. The regulations governing gain or loss from asset disposal align with the accelerated cost recovery system.

Under these regulations, gain or loss from the retirement, sale, exchange, or involuntary conversion of MACRS property is recognized according to the relevant tax code. In abandonment cases, a loss is recognized equal to the asset's adjusted depreciable basis at the time of abandonment, unless the abandoned asset is subject to nonrecourse debt, in which case the abandonment is treated as a sale. No gain or loss is recognized if an asset is disposed of by conversion to personal use.

A partial disposition occurs when a portion of a building's component is disposed of, or when a portion of an element of any other UOP is disposed of (refer to page 29 for further details).

A partial disposition election allows taxpayers to recognize a gain or loss when disposing of a portion of an asset placed in service before a tax year beginning on or after January 1, 2014. This election applies to both building and non-building properties. It is generally elective, except in cases of casualty, abandonment, like-kind exchanges, or certain other situations where it is mandatory.

By making this election, taxpayers can treat the retirement of a structural component of a fixed asset, such as a roof replacement, as a disposition. This enables them to claim a loss on the remaining undepreciated basis of the retired component. The partial disposition election aims to minimize the simultaneous depreciation of a retired element and its replacement.

Implementing this election is straightforward. Taxpayers claim a gain or loss on their timely filed original tax return (including extensions) for tax years starting on or after January 1, 2014. A partial disposition election made on or after this date does not necessitate a change in accounting method, and Form 3115 is not required.

In 2014, a taxpayer replaced a section of a building's roof. The original roof component was retired, allowing the taxpayer to deduct a loss on their 2014 tax return, based on its unadjusted basis (undepreciated basis) plus removal costs. The new roof component was capitalized and is being depreciated.

Determining the basis of retired building components replaced or demolished in the current or prior years can be challenging when claiming partial disposition loss deductions, especially without a cost segregation study. The IRS accepts cost segregation studies for this purpose and permits Producer Price Index (PPI) discounting within these studies.

Tax Treatment of Roof Replacement: Partial Disposition Election

In a 2013 case, a taxpayer who replaced an original roof and immediately expensed it as a repair was audited. The IRS determined that the replacement was a capital improvement that should have been capitalized and depreciated, thus disallowing the repair expense deduction.

In such a situation, the taxpayer can make a late partial disposition election. This allows them to deduct a loss based on the remaining adjusted basis of the old, retired roof, including the cost of its removal.

Consequences of Not Making the Election:

If the taxpayer does not make this election, replacing the old roof is not considered a disposition. Consequently:

- The taxpayer must continue to depreciate the original roof's cost.
- The taxpayer cannot recognize a loss on the retirement of the original roof.
- The taxpayer must also capitalize and depreciate the cost of the new replacement roof.

Consequences of Making the Election:

By making a late partial disposition election:

1. The retirement of the original roof is treated as a disposition.
2. The taxpayer ceases depreciation of the original roof upon its retirement.
3. The taxpayer can recognize a loss on the disposition of the original roof.
4. The taxpayer capitalizes and depreciates the cost of the new roof.

Taxpayers can claim losses for retired building components on prior-year tax returns. For example, on a 2014 return, a late partial disposition election allows the recognition of a loss on demolished Section 1245 and 1250 assets, eliminating taxes on their recaptured depreciation.

Example: Consider a $10 million building bought in 2012. A $2 million third-floor remodel in 2013 involved removing $500,000 of original Section 1245/1250 assets. By making a late partial disposition election on the 2014 return, a $450,000 loss (original basis minus prior depreciation) can be recognized.

Without this election, the continued depreciation of the removed assets leads to depreciation recapture upon the building's sale. Section 1245 recapture is taxed at ordinary rates, and Section 1250 recapture is taxed at 25%. Retroactively recognizing the loss avoids taxes on the retired assets' depreciation and ensures any capital gain on the building's sale is taxed at a maximum of 20%, potentially resulting in significant permanent tax savings.

A general asset account (GAA) simplifies asset accounting by grouping assets with the same depreciation method, recovery period, and applicable convention placed in service within the same year. Depreciation is calculated annually for the GAA as a whole. Generally, losses cannot be recognized on the disposal of a single asset within a GAA. While taxpayers can elect to use GAAs, the final tangible property regulations prohibit loss recognition on partial dispositions of assets in a GAA. Consequently, taxpayers largely avoid GAAs and may even revoke prior GAA elections through a late GAA revocation.

When determining the unadjusted depreciable basis of a disposed asset within a GAA is impractical, regulations permit the use of any reasonable method applied consistently to all assets in the same GAA. The IRS's allowance for revoking prior-year GAA elections was a rotable concession.

Form 3115

Businesses, excluding small businesses using the simplified option, must file Form 3115 if they didn't follow the final tangible property regulations previously. This is probable for most businesses since pre-2014 accounting methods for tangible property likely didn't meet these regulations. For tax purposes, a consistent accounting method means treating an item uniformly when calculating taxable income. Form 3115 is necessary for accounting method changes related to the new rules for repairs, retirements, and removal costs of tangible assets. Usually, a change in accounting method necessitates a Sec. 481(a) adjustment.

Taxpayers can use one Form 3115 for multiple accounting method changes. However, each change needs its information, including descriptions of the current and proposed methods, supporting regulations, and individual Sec. 481(a) adjustments. Generally, the IRS automatically consents to accounting method changes made to align with rules for tax years starting before January 1, 2015.

For taxpayers altering a unit of property or identifying a building structure or system to align with improvement standards, a description of each property unit in plain language is required, stating adoption of the "new tangible property regulations." Providing a comprehensive description of the property unit, building structure, and/or systems under both current and proposed accounting methods is advisable. Taxpayers switching from expensing to capitalizing and depreciating these amounts must complete Schedule E, "Change in Depreciation or Amortization," on Form 3115.

Revenue Procedures 2014-16, 2014-17, 2014-54, 2015-13, and 2015-14 detail the accounting method changes required to comply with the final tangible property regulations. These changes, which necessitate designated change numbers (DCNs) on Form 3115, pertain to: tangible property; late partial disposition elections; disposition of a building or structural components; and dispositions of tangible depreciable assets (excluding buildings or their structural components). The accounting method changes needed for compliance and late partial disposition elections are outlined in these procedures.

Modifications Related to Deducting Materials and Supplies:

- Deduct non-incidental materials and supplies they are used or consumed in the tax year.
- Deduct incidental materials and supplies when paid or incurred.
- Deduct non-incidental, rotable, and temporary spare parts in the tax year they are disposed of.
- Change to the optional method of accounting for rotable and temporary spare parts.

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Changes Related to Property Costs:

- Deduct repair and maintenance costs (including changes to the routine maintenance safe harbor) or capitalize the costs of improvements and depreciate them, including changes in identifying the unit of property.
- Capitalize amounts paid or incurred to acquire or produce property; if depreciable, depreciate it.
- Deduct amounts paid or incurred to investigate or pursue real property acquisition.

Changes Related to Asset Disposition Elections:

1. Change in grouping assets (single-asset account, multiple-asset account, etc.).
2. Change in determining the asset disposed of for buildings and structural components, including changes related to non-elective partial asset dispositions and determining the unadjusted basis of the disposed portion.
3. Change in determining the asset disposed of for property other than buildings and structural components, including changes related to non-elective partial-asset dispositions and determining the unadjusted basis of the disposed portion.
4. Change in determining the asset disposed of for assets in a GAA, including changes in determining the unadjusted basis of the disposed asset.

Other Accounting Method Changes:

- Change to the optional regulatory accounting method.
- Change by a dealer to deduct commissions and other transaction costs that facilitate property sales.

Revenue Procedures 2015-13 and 2015-14, along with the Form 3115 instructions, outline the procedures and specific rules, including designated change numbers (DCNs), for filing changes in accounting methods. Rev. Proc. 2015-14 provides tables of DCNs for modifications related to tangible property regulations and the disposition of MACRS property.

When filing Form 3115 to change accounting methods for tangible property regulations, multiple DCNs are usually required, ranging from #184 to 193. These changes may include:

- Materials and supplies (DCN #186 and 187)
- Repairs and maintenance (DCN #184)
- Capitalization and units of property (DCN #184)
- Acquisition and production costs (DCN #192)
- Real property investigatory costs (DCN #193)

Late partial asset disposition elections (available only through 2014) use DCN #196. Changing from depreciating a disposed asset or a portion thereof to recognizing a gain or loss upon disposition requires DCN #205/206. The number of necessary method changes can vary depending on a taxpayer's specific circumstances.

Form 3115 must be attached to the taxpayer's timely filed tax return for the year of change (including extensions). A copy of Form 3115 must be filed with the IRS Ogden, Utah Office no later than the tax return filing date.

Depreciation or cost recovery applies to property used for both business and investment purposes. The adjusted basis of property must be reduced by allowable depreciation, even if not claimed. Regulations specify seven asset classes. Class V includes depreciable real and personal property, excluding land. Personal vehicles are a type of Class V asset suitable for business and investment use.

Taxpayers can deduct business vehicle expenses using actual costs, including depreciation, or the standard mileage allowance. Depreciation is one element of actual costs. The other asset classes are: Class I - cash and general deposit accounts (excluding CDs); Class II - actively traded personal property (stocks and securities); Class III - debt instruments; Class IV - inventory; Class VI - Section 197 intangibles; and Class VII - goodwill and going concern value.

Depreciation of assets begins when they are "placed in service"—ready and available for their intended use in a trade, business, or income production. An asset is considered in use when all actions within the taxpayer's control to make it operational have been completed.

Important Note: Land is not depreciable and must be listed separately from any buildings or structures on it. The cost basis of land must be distinguished from the cost basis of any buildings.

Modified Accelerated Cost Recovery System (MACRS)

For property placed in service after 1986, depreciation must be calculated using the Modified Accelerated Cost Recovery System (MACRS). MACRS encompasses the General Depreciation System (GDS) and the Alternative Depreciation System (ADS), which generally differ in their depreciation methods and recovery periods.

GDS vs. ADS Usage

GDS offers three depreciation methods:

1. 200% declining balance (DB)
2. 150% declining balance (DB)
3. Straight-line (SL)

Alternative Depreciation System (ADS)
ADS uses only the straight-line (SL) method but applies it over more extended recovery periods than GDS, except for certain 5-year recovery period properties (e.g., vehicles and computers).

GDS vs. ADS Usage

Taxpayers typically use GDS unless they are legally required to use ADS or choose to elect its use.

The following types of property are specifically required to use ADS:

1. Specific "listed" property.
2. Tangible property used predominantly outside the United States during the year.
3. Any imported property covered by the President of the United States executive order.
4. Tax-exempt bond-financed property.
5. Tax-exempt use of property.

Impact of Mandatory ADS on Bonus Depreciation
If ADS is mandatory for a property, bonus depreciation is not available.

ADS Mandatory Lease Test

For residential and non-residential property, ADS is mandatory if there is a "disqualified lease." A disqualified lease is one with a term greater than 20 years, including renewal options. An exception to including renewal options is when the rental is based on the property's fair market value (FMV) at the time of renewal.

Additional ADS Examples

- A building partially financed with tax-exempt bonds will have depreciation calculated proportionally using both ADS and GDS. For example, a $10 million building financed with $5 million in tax-exempt bonds would be 50% depreciated using ADS and 50% using GDS.
- An office building leased to a government agency (a tax-exempt entity) is subject to a 35% test. If more than 35% of the building's square footage is leased to a tax-exempt entity, the entire building must be depreciated using ADS.

Election to Use ADS

Even if the property qualifies for GDS, taxpayers can choose to use ADS.

Property Converted to Business Use

If property is converted to business use, depreciation must be based on the lesser of the property's adjusted basis or its FMV on the date it is placed in service.

MACRS Conventions for When Property is Placed in Service:

Half-Year Convention:

- Applies to all property except residential rental property and non-residential real and rental property (unless the mid-quarter convention is required).
- Allows for one-half year of depreciation regardless of when the property is placed in service during the year.

Mid-Quarter Convention:

- Applies if the total cost of personal property placed in service in the last three months of the tax year is more than 40% of the total cost of all personal property placed in service that year.
- The allowable depreciation for personal property depends on the quarter it was placed in service: 1.5, 2.5, 3.5, or a full year.

Mid-Month Convention:

Applies to all real property, including residential rental property and non-residential real and rental property.

Personal property is categorized into six classes for depreciation under MACRS-GDS. The 3, 5, 7, and 10-year property classes typically use the 200% declining balance (DB) method, switching to the straight-line (SL) method when it yields a larger deduction. An election can be made to initially use either the 150% DB or the SL method. Additions or improvements are depreciated separately from the time they are placed in service.

Most personal property falls into the following classes:

- 3-Year Class: Certain manufacturing tools and devices, race horses over two years old, and qualified rent-to-own property.
- 5-Year Class: Automobiles, light and heavy-duty trucks, computers and peripheral equipment, office equipment (calculators, copiers), and farm machinery (ADS: 5 years).
- 7-Year Class: Office furniture and fixtures (desks, safes, communication equipment), some agricultural assets (specific machinery, equipment, fences), and horses held for breeding (ADS: 12 years). Any property not fitting into another class is also considered 7-year property under MACRS (ADS: 12 years).
- 10-Year Class: Agricultural trees or vines bearing fruit or nuts, and water transportation equipment.

The 15 and 20-year property classifications use the 150% DB method under GDS.

- 15-Year Property: Includes land improvements (roads, parking areas, decorative walls, landscaping, asphalt, curbs, shrubbery - ADS: 20 years), farm property, and trees other than fruit-bearing trees or vines.

20-Year Property: Includes farm buildings.

Taxpayers can elect the straight-line (SL) depreciation method for any property class. If elected, all property within that class must use SL (GDS), and this election is irrevocable.

Residential Rental Property: Depreciated over 27.5 years using the SL method under GDS (ADS uses 40 years). This includes mobile homes but excludes hotels and motels. Improvements or additions are depreciated separately from the original property when they are made. Land improvements can sometimes be depreciated over 15 years and may qualify for bonus depreciation. While Section 179 first-year expensing doesn't apply to new appliances in residential rental property (as it's for business property, not property for income production), 50% bonus depreciation and regular depreciation can be claimed for new appliances placed in service in 2015.

Non-Residential Real Property: Depreciated over 39 years using the SL method under GDS (ADS uses 40 years). Leasehold improvements are depreciated over 15 years using the SL method (ADS uses 39 years). ADS is mandatory for tangible property outside the U.S., tax-exempt property, and specific imported property. Special rules apply to short tax years (those that are less than 12 months).

Section 1031 (Like-Kind Exchange) and Section 1033 (Involuntary Conversion) Property: When both the acquired and relinquished properties are subject to MACRS, and their depreciation period and method are generally the same, the replacement property continues to be depreciated beginning in the year of replacement using the same convention, period, and method as the relinquished property.

Qualified Leasehold Improvement Property: This refers to any improvement made to the interior of a non-residential building under or under a lease. The lessee or sublessee must occupy the space. It excludes elevators, any structural framework of the building, and improvements made before January 1, 2016. These improvements are eligible for 15-year straight-line (SL) depreciation under GDS, provided the building was placed in service more than three years before the implementation of the improvement.

Restaurant buildings and improvements qualify as qualified restaurant building property if over 50% of the square footage is used for meal preparation and customer seating. This includes the entire building structure and interior costs. This applies to buildings placed in service after December 31, 2008, and before January 1, 2016. As Section 1250 property, it was eligible for 15-year GDS straight-line depreciation (ADS - 39 years) in 2015. Additionally, it qualified for Section 179 expensing up to $250,000 but was not eligible for bonus depreciation.

Qualified retail improvement property includes interior nonresidential building improvements for properties open to the public and used in the retail sale of tangible personal property. This excludes building enlargements, structural frameworks, or elevators. The property must be placed in service before January 1, 2016, and more than three years after the building's initial opening. This applies to both building owners and lessees. As Section 1250 property, it is eligible for 15-year straight-line depreciation under the General Depreciation System (GDS) as of 2015. It also qualifies for Section 179 expensing up to $250,000 but is not eligible for bonus depreciation.

For qualified new property placed in service before January 1, 2016, a 50% first-year bonus depreciation is available. This includes most equipment, software, and specific leasehold improvements. Previously, 100% bonus depreciation applied to qualified new property placed in service between September 9, 2010, and December 31, 2011; since then, it has been 50%. There is no dollar limit, and businesses of all sizes are eligible. If the addition of depreciable property results in a net operating loss (NOL), the NOL can be carried back or forward to recover taxes from those years.

Bonus depreciation is mandatory unless an election out is made, either by asset class or for all qualifying assets. It applies to new properties only; used properties do not qualify, although improvements to used properties may.

Bonus depreciation also extends to qualifying personal property in rental properties, such as appliances. The property must have a General Depreciation System (GDS) life of 20 years or less. It should be calculated and applied before regular GDS depreciation but after Section 179 expensing. Taxpayers can utilize bonus depreciation and then use a conventional depreciation method to the remaining basis.

Property initially acquired for personal use and later converted to business use in 2015 is eligible for bonus depreciation by the original owner. For both regular tax and the Alternative Minimum Tax (AMT), first-year bonus depreciation is permitted. Corporations that otherwise qualify for first-year bonus depreciation have the option to claim additional R&D tax credits or AMT credits instead of bonus depreciation through December 31, 2015. To do so, taxpayers must elect to forgo bonus depreciation on qualifying property placed in service and instead use the straight-line depreciation method. Any increases in allowable credits are treated as refundable. To claim straight-line amortization instead of bonus depreciation for the use of these credits, Form 3800 and/or Form 8827, along with Form 4562, must be filed.

Section 179 First-Year Expensing

In 2015, businesses can elect to deduct the full cost of new and used equipment and computer software in the year of purchase. To qualify, the property must be used for business purposes more than 50% of the time. Converted property and property used for investment purposes (such as rental property), estates, and trusts are not eligible for this election.

Unlike bonus depreciation, the Section 179 deduction cannot create a net operating loss (NOL) for the tax year. The deduction is limited to the taxpayer's taxable income derived from their active trade or business. However, any disallowed amount due to this limitation can be carried forward to future tax years. For individuals with a Schedule C business, the maximum Section 179 expense deduction allowed in a given year cannot exceed their taxable income, including wages reported on Forms W-2 for both spouses if filing jointly.

For 2015, the maximum Section 179 expense deduction is $500,000 annually. This allowable deduction begins to decrease when the total cost of eligible assets placed in service exceeds $2,000,000. For every dollar above this threshold, the maximum deduction is reduced by one dollar. Consequently, if a taxpayer acquired $2,020,000 of qualifying property in 2013, their maximum Section 179 deduction would be $480,000 ($500,000 - $20,000). No Section 179 deduction is available for taxpayers who place $2,500,000 or more of eligible property into service.

Taxpayers can still elect Section 179 expensing even without sufficient income in the current year, as any unused deduction can be carried back and forward to other years. Furthermore, the annual Section 179 deduction limits are increased by any Section 179 carryovers from previous years.

Section 179 allows for the expensing of depreciable machinery, personal property like computers, equipment, and furniture, as well as off-the-shelf computer software (excluding Section 1245 property). Computer software can be expensed but is then amortized over 3 years if its useful life exceeds one year (including development costs). Off-the-shelf computer software qualified for Section 179 expensing through 2015.

Through 2015, the law temporarily extended Section 179 to qualified real property, which includes:

1. Qualified leasehold improvement property costs: These cover nonresidential building interior costs (excluding elevators and the building's structural framework) that are placed in service more than three years after the building's opening.
2. Qualified restaurant property costs: These encompass both building and improvement costs if over 50% of the building's square footage is used for meal preparation and customer seating.
3. Qualified retail improvement costs: These apply to nonresidential building interior costs for buildings open to the public and used in a retail business selling tangible personal property (excluding elevators and the building's structural framework) that are placed in service within three years of the building's opening.

However, for these real properties in 2015, taxpayers were limited to $250,000 in Section 179 expensing for the total cost.

Section 179 property expensing, excluding disallowed real property, can generally be carried forward indefinitely due to the taxable income limit. However, carryover limitations exist for qualified Section 179 real property expensing. Taxpayers could use 179 expensing for real property from 2010 through 2015 and amend returns to carry over unused amounts, but not beyond 2015. Before a temporary expansion, Section 179 deductions for qualified real property could not be carried forward to tax years starting after 2011. Taxpayers can choose to exclude real property from the definition of Section 179 property.

For partnerships and S-corporations, the Section 179 determination occurs at the entity level. However, the maximum dollar and taxable income limitations apply both at the entity level and to individual partners or shareholders. The basis in Section 179 property is reduced by the allowable amount, even if partners or shareholders cannot deduct the full amount.

Listed property, defined as Section 1245 personal property, has restrictions on the amount of depreciation, bonus depreciation, and Section 179 expensing claimable annually. New listed property used more than 50% for business qualifies for GDS depreciation (200% DB), bonus depreciation, and Section 179 expensing in the year it's placed in service. Conversely, listed property used 50% or less for business must be depreciated using ADS (straight-line), and neither bonus depreciation nor Section 179 expensing is permitted. Certain listed property also faces additional depreciation limitations.

Business use of personal passenger vehicles for transportation allows taxpayers to deduct actual expenses (including depreciation) or use the standard mileage allowance. For new passenger vehicles placed in service in 2015, depreciation is further limited. Although vehicles are generally considered 5-year property, those weighing less than 6,000 pounds cannot be fully depreciated.

Depreciation limits for new luxury passenger cars (under 6,000 pounds unloaded weight) are: $11,160 in the first year (including $8,000 bonus depreciation), $5,100 in the second year, $3,050 in the third year, and $1,875 for each subsequent year. Used vehicles are not eligible for bonus depreciation, with a first-year limit of $3,160 and the same limits as new vehicles in later years. For instance, if a car is used 60% for business, the depreciation deduction in the fourth year would be $1,125 (60% of $1,875).

Trading in a vehicle for another results in a deferral of any gain or loss. The new vehicle's basis for depreciation is the adjusted basis of the old vehicle plus any amount paid in the trade-in, as it is treated as a like-kind exchange.

In 2015, depreciation limitations for new light trucks and vans under 6,000 pounds placed in service were less restrictive than for passenger cars. The first-year limit was $11,460 (including $8,000 bonus depreciation), followed by $5,600 in the second year, $3,350 in the third year, and $1,975 for each subsequent year. For used trucks and vans, the first-year limit was $3,460.

SUVs, trucks, and vans weighing between 6,000 and 14,000 pounds placed in service in 2015 were exempt from the annual depreciation caps applicable to passenger vehicles and lighter trucks/vans. However, a $25,000 annual limit applied to the Sec. 179 expense deduction for these vehicles. As listed property used for transportation, these vehicles were still subject to two restrictions if business use was 50% or less: depreciation was limited to the Alternative Depreciation System (ADS), and bonus depreciation and Sec. 179 expensing were not allowed.

For example, a new $50,000 SUV used 100% for business purchased on January 1, 2015, could take a $25,000 Sec. 179 deduction, $12,500 (50%) bonus depreciation, and 20% depreciation on the remaining $12,500, resulting in a total first-year write-off of $40,000.

Particular trucks and vans weighing over 6,000 pounds but under 14,000 pounds were entirely exempt from the reduced depreciation rules, including the $25,000 Section 179 expense limitation. This exemption applied to:

- Vehicles designed to seat more than nine passengers behind the driver. Examples include many hotel shuttles and vans.
- Vehicles with a cargo area not easily accessible from the passenger area and at least 6 feet long internally. This includes many pickups with full-size cargo beds (6 feet or longer). Some "quad cabs" and "extended cabs" with shorter beds may not qualify. The cargo area can be open or covered by a cap.
- Vehicles with an integral enclosure for both the driver and cargo, no seating behind the driver, and a body section extending no more than 30 inches ahead of the windshield (stub-nosed vehicles). Many delivery vans meet this criteria.

Leased Passenger Vehicles: The cost deduction for leasing passenger vehicles is limited. This limitation is calculated as an income inclusion amount based on a formula and tables provided in Reg. Sec. 1.280F-7. The IRS releases updated tables outlining these income inclusion amounts for lessees of passenger automobiles and for trucks and vans with lease terms starting in calendar year 2015. This rule applies only when the actual cost of leasing and other vehicle expenses are deducted as a business expense, rather than using the standard mileage allowance. The standard business mileage allowance can still be used for leased cars, trucks, and vans.

Listed Property Other Than Vehicles:

1. Property for entertainment, recreation, or amusement: This includes photographic, phonographic, and video recording equipment, unless it is used exclusively (100%) for the taxpayer's trade or business.
2. Computer and peripheral equipment: Unless used 100% in the taxpayer's regular business establishment (including a home office), this is considered listed property. However, depreciation on a computer used for managing investments can be claimed as an investment deduction (miscellaneous itemized deduction), regardless of whether it's primarily used for business. Note that computers used solely for managing investments are always classified as listed property.
3. Cell phones and similar telecommunications equipment: As of 2010, these are no longer classified as listed property. Consequently, employers who provide cell phones to employees

or reimburse them for business use can apply for tax-free treatment without requiring extensive record-keeping.

Vehicles used 50% or less for business that are not "listed property" are eligible for GDS (200% DB) depreciation without limitations on Section 179 expensing and bonus depreciation.

Non-personal use vehicles not considered listed property include:

- Ambulances and hearses
- School buses
- Dump trucks
- Fire trucks
- Tractors and combines
- Cement mixers
- Trucks and vans modified explicitly for business use (e.g., shelving, advertising)
- Taxis, buses, or vans used for transporting people for compensation
- Vehicles designed to carry cargo and weighing over 14,000 pounds
- Boats used for transportation (if qualified non-personal use vehicle)
- Planes used for transportation (if qualified non-personal use vehicle)

Non-Listed Personal Use Property:

- Furniture and equipment.
- Photographic, phonographic, communication, or video recording equipment used exclusively (100%) for the taxpayer's principal business.
- Computers and peripherals used at a regular business establishment, including a home office used 100% for business.
- Cell phones and similar telecommunications equipment (typically 100% deductible if a home phone line exists and the cell phone is needed for business).

Conversion of Listed Property (e.g., car, truck):

- When listed property used predominantly (over 50%) in a business is converted to personal use (under 50% business use), excess depreciation must be recaptured as ordinary income.
- Recaptured depreciation includes the difference between 200% declining balance (GDS) and straight-line depreciation (ADS), as well as any Section 179 expensing and bonus depreciation taken.
- This recapture is reported on Form 4797 and added to the property's basis.
- The recapture period for listed vehicles ends after 6 years (the normal ADS recovery period).
- Depreciation can continue after 6 years if the vehicle is not fully depreciated.

Conversion of Other Business Property (Not Listed):

- If other business property (not considered listed) is converted to personal use, it is treated as disposed of in that year.
- No gain, loss, or depreciation recapture is recognized upon this conversion.

The energy-efficient commercial building deduction under Section 179D, effective through 2015, allows for an immediate depreciation deduction of up to $1.80 per square foot. This applies to new construction, renovations, or retrofits of commercial and multifamily residential buildings (over three stories) placed in service between 2006 and 2015. To qualify, the building must achieve a 50% reduction in total energy and power costs, verified by a qualified professional engineer or contractor using IRS-prescribed software. This deduction accelerates typical 39-year depreciation deductions and reduces the building's tax basis.

Engineers must analyze three primary building components for potential energy efficiency deductions, ranging from $0.30 to $0.60 per square foot. Partial deductions require a 25% to 40% reduction in energy costs. These components include: (1) interior lighting systems; (2) HVAC (heating, ventilation, and air conditioning) systems; and (3) the building envelope. The building envelope is the outer shell protecting the indoor environment and facilitating climate control; it includes insulation, windows, wall upgrades, reflective coatings (such as low-E coatings on window exteriors to reduce heat gain and interiors to retain heat in colder climates), green roof systems, cool roof systems, insulation and sealant systems, and insulated exterior cladding. For government buildings, the architect is eligible to claim this deduction. Taxpayers should claim the 179D deduction under "other deductions" on Form 1040 with the description "179D." IRS Revenue Procedure 2011-14, released in 2012, allows taxpayers to claim the 179D deduction retroactively to the 2006 tax year using an automatic "change of accounting" method instead of amending previous tax returns, which is a significant benefit for eligible taxpayers.
A cost segregation study, performed by a qualified engineering company accepted by the IRS, helps building owners accelerate depreciation deductions. For existing buildings placed in service since January 1, 1987, this study identifies building costs and land improvements typically depreciated over 27.5 or 39 years and reclassifies them as property with shorter depreciation periods of 5, 7, or 15 years.

This reclassified property includes Section 1245 personal property such as windows, electrical wiring, track and decorative lighting, wall paneling, counters, freezers, flooring, and wall partitions (5 and 7-year depreciation), as well as site or land improvements like sidewalks, sewers, and curbs (15-year depreciation).

Cost segregation enables the proper identification of an asset's cost basis, property class, and recovery period, leading to accelerated depreciation deductions, a lower tax liability, and improved cash flow. While it accelerates depreciation, it doesn't increase the total depreciation amount, as all capitalized building costs will eventually depreciate fully. However, the time value of money makes a cost segregation study beneficial because a tax deduction today is more valuable than one in the future.

Taxpayers should consider a cost segregation study when expenditures for a structure, including leasehold improvements, equal or exceed $750,000. It should be performed after construction or acquisition, following significant capital improvements, during construction of properties, and after a change in ownership.

Qualifying properties include apartment buildings, retail stores, restaurants, office buildings, manufacturing facilities, wineries, grocery stores, hotels, and warehouses.

Cost segregation studies now offer more than just accelerated depreciation. They can also provide essential documentation for applying the new tangible property regulations by setting Unit of Property (UOP) baseline amounts and determining the value of disposed assets for expensing. These studies categorize a building and its systems into the main units required by these regulations.

Depletion, similar to depreciation, is the method for recovering the cost of natural resources. For royalty owners, this includes income derived from oil and gas royalties. There are two methods of depletion: percentage depletion and cost depletion.
Percentage depletion allows a deduction based on the property's gross income. It is primarily available to royalty owners and independent producers who meet specific production limits, such as 1,000 barrels of average daily domestic crude oil or its equivalent in natural gas. Royalty owners commonly use percentage depletion, which often provides a statutory deduction of

15% of the property's gross income. However, percentage depletion is subject to two limitations:

1. 100% Taxable Income Limitation: The depletion deduction cannot exceed 100% of the property's taxable income, which is the gross income less allowable deductions like severance taxes and administrative expenses.
2. 65% Taxable Income Limitation: This limit is based on the taxpayer's taxable income calculated without considering depletion, any IRC par. 199 deduction, net operating loss carrybacks, or capital loss carrybacks. This limitation may apply when a taxpayer has losses in other businesses that offset royalty income. Any disallowed amount can be carried forward and deducted in the following year.

Cost depletion allows a deduction based on the proportion of units sold to the total units available at the end of the year plus the units sold during the year. The IRS requires taxpayers to claim the greater of cost depletion or percentage depletion.

Key changes regarding percentage depletion for oil and gas include: the elimination for marginal wells starting in 2012 (American Taxpayer Relief Act of 2012); the ineligibility of lease bonuses, advance royalties, and payments unrelated to production; and the requirement to treat gains from royalty property dispositions as ordinary income to the extent depletion reduced the property's basis. Depletion calculations occur at the partner level for partnerships and the shareholder level for S-corporations. Capitalized drilling and development costs are included in the depletable amount and the property's basis, with depletion recapture taxed as ordinary income upon sale. Notably, percentage depletion for oil and gas royalty owners is not considered a tax preference item for the Alternative Minimum Tax (AMT). Percentage depletion also applies to other natural resources like mines and timber, potentially with different rates.

You can typically deduct the costs of Section 197 intangible assets over 15 years (180 months) if they are related to your business or an income-producing activity. This amortization period starts in the later of the month you acquire the intangible or the month your business or income activity begins. You cannot deduct amortization in the month you sell the intangible. Suppose you increase the basis of an intangible after the 15-year period has started. In that case, you amortize the increase over the remaining portion of the 15 years, beginning in the month the increase occurs.

Section 197 intangibles include: goodwill; going concern value; workforce in place; business records and operating systems, or any information base including customer lists; patents, copyrights, formulas, processes, designs, patterns, literary works, know-how, formats, or similar items; customer-based intangibles; supplier-based intangibles; licenses, permits, or other rights granted by a government entity (including renewals); covenants not to compete made in connection with acquiring an interest in a business; and franchises, trademarks, or trade names.

Intangible assets can be amortized over 15 years if they have an ascertainable value and a limited lifespan, although a safe-harbor rule exists. Generally, purchased goodwill and going concern value are amortizable.

Goodwill is the value derived from expected continued customer patronage, driven by factors such as a strong name and reputation. Going concern value is the additional value because the property is part of an ongoing business, including its ability to continue functioning and generating income despite ownership changes.

Corporate goodwill, representing intangible qualities leading to continued patronage, is a separate asset that can be sold, with the gain taxed as capital gain. The buyer can amortize this on a stepped-up basis, which is often the case in sales of closely held corporations.

Personal goodwill is distinct from corporate goodwill and arises from an individual's attributes and relationships, representing a separate asset. Its sale is considered compensation to the individual. In a corporate sale, a separate sale of a shareholder's goodwill can result in the gain being taxed to the shareholder at long-term capital gain rates. Personal goodwill exists when an owner's reputation, expertise, skills, knowledge, and customer relationships are crucial to the business's success and value.

Section 4 - Detailed Discussion of Key Concepts

FAQ: Understanding Tangible Property Regulations (TPRs)

The **Tangible Property Regulations (TPRs)**, which are mandatory IRS rules for businesses to classify expenses on tangible property, like buildings, as either immediate expenses or costs to be capitalized and depreciated. It emphasizes key concepts such as the **Unit of Property (UOP)** and building systems for proper expense analysis. It outlines elective **Safe Harbors** that allow expensing of certain routine or smaller expenditures. The source also details when the **RABI rules** apply to determine if an expenditure must be capitalized and explains how **IRS Code Section 481(a)** allows for adjustments to past depreciation and how a **Partial Asset Disposition (PAD)** can provide immediate tax deductions for removed property components.

1. **What are the Tangible Property Regulations (TPRs), and why were they implemented?**
    - The Tangible Property Regulations (TPRs) are mandatory tax rules that provide guidelines for businesses to determine whether costs incurred on tangible property, particularly real estate, should be immediately expensed or capitalized and depreciated over time. They were implemented starting January 1, 2014, to provide a more transparent, more structured framework for these decisions, consolidating decades of inconsistent case law and administrative rulings. The goal was to reduce conflict between taxpayers and the IRS and offer a more predictable method for handling tangible property expenses.
2. **Are the Tangible Property Regulations optional?**
    - No, the Tangible Property Regulations are not optional. Compliance with the TPRs is mandatory for all taxpayers who incur costs to acquire, improve, or produce tangible property. Failure to comply can lead to serious consequences, including the IRS denying past, present, and future depreciation claims, potentially resulting in significant financial loss, penalties, and interest.
3. **What is the Unit of Property (UOP) and why is its identification important?**
    - The Unit of Property (UOP) framework is essential for applying the Tangible Property Regulations. For buildings, each standalone structure is generally considered an individual UOP. Correctly identifying the UOP is crucial because the IRS uses this framework to determine how expenses related to repairs, improvements, or replacements are treated for tax purposes. Misidentifying the UOP can lead to incorrect capitalization or expensing decisions, potentially resulting in missed tax savings or non-compliance with IRS regulations.
4. **How are building systems relevant to the Tangible Property Regulations?**
    - Once the Unit of Property (UOP) for a building is determined, the building is further broken down into specific building systems for analysis under the TPRs. These systems encompass categories such as HVAC, electrical, plumbing, and fire protection, among

others, totaling up to nine categories. Understanding the value and nature of expenditures related to each building system allows property owners to make informed decisions on whether costs should be capitalized or expensed, which helps optimize tax benefits and ensure compliance.

5. **What are the Safe Harbors available under the TPRs?**
    - The TPRs offer several elective, simplifying provisions known as Safe Harbors that allow certain expenditures to be expensed without detailed scrutiny. These are administrative conveniences designed to reduce the burden on taxpayers for smaller or routine items. The key Safe Harbors include the De Minimis Safe Harbor (DMSH) for small purchases under a specified threshold (currently $2,500 per item on an invoice, with specific conditions), the Safe Harbor for Small Taxpayers (STSH) which allows eligible small businesses to expense costs up to the lesser of 2% of the building's adjusted basis or $10,000 annually, and the Routine Maintenance Safe Harbor (RMSH) which allows expensing of costs for maintenance reasonably expected to be repeated within 10 years to keep an asset in normal operating condition, provided the maintenance doesn't improve, enlarge, or materially increase efficiency.
6. **When do the RABI rules apply?**
    - The RABI rules (Restoration, Adaptation, Betterment, Improvement) are considered when Safe Harbors do not apply to determine whether an expenditure on a tangible property component must be capitalized or can be expensed. Costs must be capitalized if they fall under: **Restoration** (repairs within two years of occupancy or to an asset in total disrepair), **Adaptation** (changing the original intended use of an asset), **Betterment** (making a component more than 10% more efficient, larger, or significantly more valuable), or **Improvement** (affecting more than 33% of all like components). If an expenditure repairs a component to maintain its everyday normal operating condition more than two years after occupancy, it can typically be expensed under the general repair rules, unless it falls under one of the RABI capitalization criteria.
7. **How does IRS Code Section 481(a) relate to the Tangible Property Regulations?**
    - IRS Code Section 481(a) provides an opportunity for taxpayers to revisit and adjust their depreciation schedules, even though the TPRs are mandatory. This section allows businesses to potentially expense repairs that were previously capitalized if those costs would now be expensable under the current TPR rules. This is an adjustment to a taxpayer's accounting method. While mandatory for businesses with average annual gross receipts (AAGR) over $10 million to avoid potential disallowance of future depreciation, it is optional for businesses with AAGR under $10 million, and failure to adjust will not result in disallowance of future depreciation for these smaller taxpayers as long as they remain below the threshold. Eligibility for a Section 481(a) adjustment under Section 263(a) generally requires the taxpayer to have been following the RABI rules since 2015, although applying only the safe harbors does not preclude taking advantage of a 481(a) adjustment.
8. **What is a Partial Asset Disposition and what are its benefits?**
    - A Partial Asset Disposition (PAD) is a tax provision that allows a building owner to write down the remaining depreciable basis of specific items that are removed during a renovation project. This includes the costs associated with the removal and disposal of these assets. The benefit of a PAD is that it allows for an immediate tax deduction in the current year for the remaining value of the retired asset, which might otherwise have been depreciated over a longer period or only recognized upon the sale of the entire property. It's a "use it or lose it" opportunity, meaning the deduction must be taken in the tax year the renovation occurred to be claimed. Performing a PAD also helps to clean up depreciation schedules by removing assets that are no longer in use.

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Dispositions

17) Are retroactive asset accounts essential for property construction?

Taxpayers can annually elect to recognize a retirement loss for any part of a building under the proposed regulations, which could have been adopted as early as 2012 or 2013. These proposed rules represent a significant departure from prior temporary regulations, as they do not allow for partial retirement if the building is held in a general asset account. Instead, to retire a portion of the building, taxpayers recognize its allocated basis on their tax return for the year of disposition without making an explicit statement. Furthermore, differing from the 2011 temporary regulations, the proposed rules treat original structural components as part of the building asset, thus eliminating the need for a separate definition of "structural component" for disposition purposes.

18) What are the drawbacks of choosing general asset accounts according to the updated regulations?

The proposed regulations' general asset account (GAA) election has a drawback: partial asset dispositions within a GAA are disallowed. Despite this, some companies, particularly those with losses, might use GAA rules to boost future income from asset disposals. GAAs also appeal to companies seeking simpler asset disposition tracking and accounting methods.

19) What steps should I follow to make a partial disposition election? How far back can I go to execute this election?

A partial disposition election is made by reporting the gain or loss on the tax return for the year the disposition occurred. No specific declaration is needed. An early election is allowed for 2012 (with an extended amendment period) or 2013.

20) If my building improvements aren't listed in the GAAs and I disposed of them physically in a previous year, am I using an incorrect method by still depreciating them?

The proposed regulations create uncertainty regarding the continued depreciation of building improvements after their physical disposal. For instance, a lessor who remodels tenant spaces for each new lease might have numerous physically disposed improvements that are still being depreciated. Current guidance allows a method change to write off the basis of previously retired improvements via a section 481(a) adjustment. However, the shift to an annual election raises questions about the permissibility of such method changes in the future.

IRS FAQ for Tangible Property Regulations

These 42 IRS questions are in sequential order. **Click here** to visit the IRS FAQ website.

Answers to the 42 IRS questions below can be found on the IRS website in the order listed.

1. Do the final tangible regulations apply to you?
2. Do the final tangible property regulations apply to nonprofits?
3. A de minimis safe harbor election
4. What is the de minimis safe harbor election?
5. If you use the de minimis safe harbor, do you have to capitalize all expenses that exceed the $2,500 ($500 before Jan. 1, 2016) or $5,000 limitations?
6. What if you don't have an AFS but have had a policy for your books and records of deducting the costs of acquiring or improving tangible property less than a specified dollar amount but that amount exceeds the de minimis safe harbor ceiling of $2,500 ($500 before Jan. 1, 2016)?
7. How do you elect to use the de minimis safe harbor?
8. How does the de minimis safe harbor affect the deductions you typically take for materials and supplies or repairs and maintenance?
9. How does the increase in the de minimis threshold from $500 to $2,500 effective Jan. 1, 2016, affect years prior to Jan. 1, 2016?
10. Clarified rules for the treatment of materials and supplies costs
11. How do the final tangibles regulations governing deductions for materials and supplies differ from previous rules?
12. What is included in the definition of materials and supplies?
13. When can you deduct the costs of materials and supplies?
14. What must you do to apply the final tangibles regulations to materials and supplies?
15. A regulatory framework for analyzing whether expenditures are for deductible repairs or capital improvements.

16. Have the final tangibles regulations changed the rules for determining whether an expenditure is a deductible repair or a capital improvement?
17. What is the facts and circumstances analysis for distinguishing capital improvements from 48 deductible repairs?
18. Step 1 – What is the unit of property to which you should apply the improvement rules?
19. Step 2 – Is there an improvement to the unit of property, or in the case of a building, the building structure or any key building system, identified in Step 1?
20. What are the simplifying alternatives to the facts and circumstances analysis?
21. Safe harbor election for small taxpayers;
22. Safe harbor for routine maintenance; and
23. Election to capitalize repair and maintenance costs.
24. Safe harbor election for small taxpayers
25. Safe harbor for routine maintenance
26. What are the most important exceptions from and inclusions in the routine maintenance safe harbor?
27. *What must you do to apply the safe harbor for routine maintenance to amounts paid for repairs and maintenance?*
28. Election to capitalize repair and maintenance costs
29. How do these final tangibles regulations coordinate with other provisions of the IRC?
30. When and how do you apply the final tangibles regulations?
31. What is the effective date?
32. When and how do you make an election provided under the final tangibles regulations?
33. When and how do you change a method of accounting to use the final tangibles regulations?
34. General procedures
35. Reduced filing requirements for small business taxpayers
36. Simplified procedures for small business taxpayers
37. Did you qualify for this simplified procedure?
38. What are total assets?
39. How do you determine annual gross receipts?
40. What if you have multiple trades and businesses and only some qualified for the safe harbor?
41. What should you know about using the simplified procedure for your trade or business?
42. What should you know about using the simplified procedure and its effect on method changes under the final tangibles regulations for future years?

THE END OF THIS BOOK