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The Property Life Cycle: Planning for Effective Cost Segregation Strategies

New regulations create more cost segregation complexities and opportunities, making tax planning more complicated.

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With renewed expectation of comprehensive federal tax reform and a corresponding reduction in corporate rates, tax planning strategies that usually provide only timing benefits, such as cost segregation studies, may become much more effective. Strategies to move deductions from a lower-tax rate year to a higher-tax rate one will provide a permanent rate benefit in a falling tax rate environment. A recent discussion about cost segregation in a previous issue of Development magazine (“Cost Segregation Is Just the Beginning,” Bruce Johnson, summer 2016) made the point that there are more cost segregation complexities and opportunities under the new tangible property regulations (TPRs). This article examines those areas of complexity and opportunity.

In matters of tax depreciation and capitalization rules, building owners should think comprehensively about how tangible property rules interact as a property progresses through its life cycle. In September 2016, the IRS issued an audit techniques guide for agents examining taxpayers’ adoption of and adherence to TPRs. In that guide, the IRS states that “the final regulations fundamentally change the way we examine the tax treatment of buildings. Under these regulations, the acquisition, depreciation, improvement, restoration, adaptation, and disposition of a building and its structural components are interrelated. As a result, an audit of one event must include consideration of the others.”

One of the new opportunities brought forth in the Modified Accelerated Cost Recovery System (MACRS) disposal regulations that were published concurrently with the TPRs is the partial disposition election. A taxpayer incurring facility renovation costs that result in an improvement should consider the benefits of making this election to recognize a loss on the disposal of a portion of the asset. A companion provision in the TPRs allows a taxpayer making the election to also currently deduct the removal costs or costs of demolition.

It is important to note that the partial disposition election is a prerequisite to currently deducting the removal costs. If the election is not made, then the removal costs must be capitalized to the improvement. While these provisions present two lucrative opportunities for taxpayers, they also make it necessary to plan for the benefits in a timely and coordinated fashion.

Timing Is Essential

The types of facility renovation projects that give rise to these disposition and demolition benefits often take place over a number of months or even years. However, the demolition activities giving rise to these benefits generally occur near or at the beginning of a renovation project. Because the deductions are current period opportunities, they must be accounted for properly on the tax return for the year the cost was incurred or invoiced. Historically, taxpayers simply would wait until the project was complete to begin evaluating how to segregate the costs. Waiting that long, however, may result in a loss of these new opportunities.

Consider the following example: In November 2015, Company Y, a calendar-year taxpayer, begins a complete renovation that will result in an improvement to its headquarters. Company Y completes the demolition of the existing structural components in December 2015 and files its 2015 federal income tax return on Sept. 15, 2016. The project is completed on Oct. 1, 2016.

In November 2016, Company Y commissions a cost segregation study to help it properly account for the costs of the project. In December 2016, the cost segregation provider informs Company Y that it likely missed the opportunity to take a partial disposition loss on the old headquarters components and to deduct the costs of demolition because it failed to do so on its 2015 tax return. The only remaining avenue for pursuing the benefits would be through the uncertain and potentially costly late election relief provisions of Treasury Regulation Section 301.9100-3.
Ownership Is Important

Another hurdle to obtaining this new benefit relates to the issue of ownership. While some commentary suggests there is ambiguity on this point, the TPRs seem to require that a taxpayer first take the loss on the partial disposition to deduct the removal costs.

This requirement will present a challenge when the entity incurring the cost of the renovation is a tenant and the property the tenant is removing is, in fact, the landlord’s property. Therefore even though the tenant incurs the cost of removing the old items, it may not deduct that cost because it cannot take the partial disposition loss.

In this situation, a taxpayer should proactively consider two possibilities that would allow it to deduct the removal costs. First, the taxpayer/tenant should consider whether any of the items being removed are tenant improvements that it originally placed in the facility. If that is the case, the taxpayer/tenant will meet the ownership requirement.

Another situation in which a proactive taxpayer can plan for optimizing its outcome is when the tenant and landlord are related parties. In this scenario, the related group management could consider the disposition and removal cost rules when determining which party should incur the cost of renovating the property. If otherwise advisable, the related group management may determine that the landlord should incur the cost of renovation. Since the landlord is the owner of the underlying property, it may then maximize its deductions under the disposal and removal cost rules.

Proceed With Caution

Proper tax accounting for the life cycle of a property has become more complex with the advent of the TPR and related MACRS disposal regulations. Because issues such as repairs, improvements, disposals and depreciation methods are now interrelated, a simple reactive approach may no longer be sufficient. Taxpayers who consider all of these interrelated issues in a timely manner at each critical point will best optimize the tax benefits throughout the life cycle of the property.

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