Understanding Asset Dispositions Under the Tangible Property Regulations

Guest Author: Andy Rose, Rehmann Group
Foster Swift Agricultural Law Update
December 11, 2014

PRACTICE AREAS
Agri-Business

The IRS issued final regulations regarding the proper tax treatment of dispositions of tangible depreciable property under the Modified Accelerated Cost Recovery System (MACRS). The regs largely complete the IRS's overhaul of the federal tax regulations addressing the proper treatment of expenditures incurred in acquiring, producing or improving tangible assets. The final regs affect all taxpayers who dispose of MACRS property.

"The final regs apply to tax years beginning this year, 2014," said Andy Rose, a tax principal with Rehmann. "This is a very big deal – one of the biggest, tax-wise, to come down the pike in a few years."

Rose recommends a very proactive approach for taxpayers on repair regs.

"In many ways, the new rules are more liberal than the old rules, so some items that were previously capitalized must now be expensed. This will result in tax deductions for many taxpayers – and in some cases, these could be significant," he said. "Meeting with your tax advisor as soon as possible will help them help you fully leverage the new regs."

BACKGROUND

For most tangible business assets with a useful life of more than one year, taxpayers generally must depreciate the capitalized cost, or basis, over a specified period of years. The number of years — typically three, five or seven — depends on the asset class. In most cases, the MACRS is preferable to the straight-line depreciation method because it provides larger deductions in the early years of an asset's life.

But when an asset is disposed of before it's been fully depreciated under MACRS, what's the tax impact? Temporary regulations issued in 2011 addressed this situation. The final regs retain most of the temporary regs' provisions but make a few changes.

DEFINING "DISPOSITION"

Under the final regs, a disposition of an MACRS asset occurs when ownership is transferred or the asset is permanently withdrawn from use. It includes an asset's:

- Sale
- Exchange
- Retirement
- Physical abandonment
- Destruction

It also includes the retirement of a building's structural components (or a portion thereof, such as a roof) to which the partial disposition rule applies.

The partial disposition rule allows taxpayers to claim a loss on the disposition of a component (structural or otherwise) of an asset without having identified the component as an asset before the disposition. The rule reduces the number of cases where an original part and any subsequent replacements of that part must be capitalized and depreciated simultaneously.

The partial disposition rule generally is elective. But it's mandatory in certain circumstances, including for dispositions that result from a casualty event (for example, a fire or storm) or a like-kind exchange.

The final regs also include a special partial disposition rule for situations where the IRS disallows a taxpayer's repair deduction for the amount paid or incurred for the replacement of a portion of an asset and requires capitalization of that amount. In such cases, the taxpayer can make the partial disposition election for the disposition of the portion by filing an application for change in accounting method, as long as the taxpayer owns the larger asset at the beginning of the year of change.

Generally, the specific facts and circumstances of each disposition are considered when determining the disposed asset for tax purposes. But the final regs make clear that the asset may not consist of items placed in service by the taxpayer on different dates.

Further, the unit of property as determined under Treasury Regulations Sec. 1.263(a)-3(e) (the rules regarding the proper tax treatment — capitalization or expensing — of amounts paid to improve tangible property) doesn't apply for purposes of determining the appropriate disposed asset.

The final regs provide special rules for certain types of properties. For example, each building (including its structural components) is the disposed asset unless:

- More than one building is treated as the asset
- An existing building has an improvement or addition (the improvement or addition is then a separate asset)
- The building includes two or more condo or cooperative units (each unit is a separate asset)

Similarly, if the taxpayer places in service an improvement or addition to a non-building asset after the asset was placed in service, the improvement or addition is a separate asset.

DETERMINING GAIN OR LOSS

If an asset is disposed of by sale, exchange or involuntary conversion, then gain or loss is recognized under the applicable section of the Internal Revenue Code. When an asset is disposed of by physical abandonment, on the other hand, loss is usually recognized in the amount of the asset's adjusted depreciable basis at the time of the abandonment. If the abandoned asset is subject to nonrecourse indebtedness, the asset is treated as a sale.

When an asset is disposed of in some manner other than abandonment, sale, exchange, involuntary conversion or conversion to personal use (for example, when the asset is moved to a supplies or scrap account), gain isn't recognized. Loss is recognized in the amount that the asset's adjusted depreciable basis exceeds its fair market value at the time of disposition.

DETERMINING BASIS

When a disposed asset is in a multiple-asset account and it's impracticable from the taxpayer's records to determine the asset's unadjusted depreciable basis, the final regs allow the taxpayer to use "any reasonable method" to determine the basis. The method must, however, be consistently applied to all assets in the same multiple-asset account. According to the final regs, reasonable methods include:

- Discounting the cost of the replacement asset to its placed-in-service year cost using the Producer Price Index for Finished Goods, the Producer Price Index for Final Demand or any other designated index
- A pro rata allocation of the unadjusted depreciable basis of the multiple asset account based on the replacement cost of the disposed asset and the replacement cost of all of the account's assets
- A study allocating the asset's cost to its individual components (for example, a cost segregation study)

A taxpayer can also use a reasonable method when the partial disposition rule applies and it's impracticable to determine unadjusted depreciable basis from the taxpayer's records.

Taxpayers generally must use the specific identification method to determine a disposed asset's placed-in-service year (the year a taxpayer can begin claiming depreciation on the asset). Under the method, if an asset is in a multiple-asset account and it's impracticable from records to determine the year, the taxpayer can use a first-in, first-out (FIFO), modified FIFO or other designated method (but not a last-in, first-out method).

The same methods can be used when the partial disposition rule applies and it's impracticable from records to determine the year.

USE OF GENERAL-ASSET ACCOUNTS

The final regs allow taxpayers to maintain general-asset accounts for MACRS property. When an asset in such an account is disposed of, the proceeds are generally treated as ordinary income.

The regulations also include rules for establishing, depreciating and disposing of assets in general-asset accounts, as well as how to determine basis and placed-in-service year. Each general-asset account is treated as the asset.

WHAT TO DO NEXT

According to Rose, getting moving won't take too much. He broke it down as follows:

1. Up first: meet with your advisor to review the effect of these new regulations on your business.
2. From there, your advisor's goal will be to begin to determine which accounting method changes are needed to get you in compliance.
3. When your tax advisor completes the project for you, it will include computing any tax deductions that result from adopting the regulations. Also up for discussion: annual elections created by the new regulations that may be beneficial for you to make on your future tax returns.

"But you have to make that important call to your advisor," he said, "if they haven't already reached out to you."

Rehmann advisors recently underwent extensive training on the new regulations. To learn how they can help you immediately, contact Rehmann at 866.799.9580 or visit rehmann.com.

This article was reprinted with Rehmann's permission.