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# ***Final tangible property repair regulations and proposed regulations: Dispositions, general asset accounts, recovery of certain capital improvements, and removal costs***

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## ***In brief***

This is the third WNTS Insight in a three-part series discussing in depth the recently issued final repair regulations regarding the deduction and capitalization of expenditures related to tangible property (final repair regulations) and the accompanying proposed regulations regarding dispositions (2013 proposed regulations). This Insight discusses the 2013 proposed regulations.

The first Insight discussed rules related to effective dates, materials and supplies, the de minimis rule, and rotatable spare parts. (See WNTS Insight, "[Final tangible property repair regulations: Effective dates, materials and supplies, de minimis rule, and rotatable spare parts](#)," September 18, 2013.) The second Insight discussed rules related to the definition of a unit of property (UOP) and the acquisition or improvement of property. (See WNTS Insight, "[Final tangible property repair regulations: Unit of Property and acquisition or improvement of property](#)," September 26, 2013.) This Insight discusses the proposed regulations regarding dispositions and general asset accounts (GAA) along with the recovery of capital improvements subject to leases and removal costs.

Taxpayers may apply the temporary repair regulations issued in 2011 (2011 temporary regulations) at Reg. sec. 1.168(i)-1T and Reg. sec. 1.168(i)-8T to tax years beginning on or after January 1, 2012, but the 2013 proposed regulations provide that taxpayers may not apply the 2011 temporary regulations to tax years beginning on or after January 1, 2014.

The IRS stated in the preamble to the 2013 proposed regulations its plan to finalize these regulations in 2013 with application to tax years beginning on or after January 1, 2014. If the 2013 proposed regulations are not finalized until 2014, taxpayers should be aware of the possibility that the final regulations for dispositions could be applied retroactively to tax years beginning on or after January 1, 2014.

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## In detail

### Dispositions

The 2013 proposed regulations generally retain the definition of dispositions from the 2011 temporary regulations. In general, a disposition occurs when ownership of an asset is transferred or the asset is permanently withdrawn from use. A disposition of an asset includes sale, exchange, retirement, physical abandonment, destruction, and transfer to a supplier, scrap, or similar account. However, the 2013 proposed regulations would provide significant changes to the rules relating to the determination of the asset disposed of and a qualifying disposition of an asset in a GAA, along with new rules for partial dispositions of assets.

**Observation:** A taxpayer that has made an election to capitalize certain materials and supplies (rotable spare parts, temporary spare parts, or standby emergency spare parts) must obtain IRS consent to revoke that election before it may dispose of the property by transferring it to a supplies account.

### Asset disposed of

The proposed rules for determining the asset disposed of for MACRS property other than buildings or structural components are similar to those in the 2011 temporary regulations. For items included in asset classes 00.11 through 00.4 of Rev. Proc. 87-56 or for items properly classified in a category under Section 168(e)(3) (with the exception of a category that includes buildings or structural components), each item is considered a separate asset. For example, each desk is the asset, each computer is the asset, and so on. In addition, an improvement or addition to an asset that is placed in service after the asset's original placed-in-service date also is considered a separate asset.

While the rules for determining the asset disposed of for certain MACRS property remain consistent with the 2011 temporary regulations, the 2013 proposed regulations would provide significant changes relating to determining the asset disposed of for buildings and structural components.

The 2011 temporary regulations expanded the definition for dispositions of MACRS property to include the retirement of a structural component of a building. Under the temporary regulations, structural components of a building are considered an asset for tax disposition purposes and thus require taxpayers to recognize a gain or loss on the disposition of any structural component of a building unless a GAA election is made.

The 2013 proposed regulations would change this rule to provide that a building, including its structural components, is the asset for disposition purposes. In addition, the definition of a disposition would be modified to include the retirement of a structural component (or a portion thereof) of a building only if the partial disposition rule (discussed below) applies to such structural component (or a portion thereof). This change would allow taxpayers to forgo a loss upon disposition of a structural component of a building without making a GAA election, and therefore would eliminate the potential administrative burden related to tracking the components in separate or specific GAAs.

**Observation:** The mandatory requirement in the 2011 temporary regulations to recognize a gain or loss on the disposition of any structural component of a building results in potential allowed versus allowable basis issues that generally would be resolved by the changes in the 2013 proposed regulations.

### Partial dispositions

The most significant change in the 2013 proposed regulations is the inclusion of new rules related to partial dispositions of assets included in a single-asset account, in a multiple-asset account (MAA), or in a GAA.

#### Assets not included in a GAA (MAAs and single-asset accounts)

Under the 2013 proposed regulations, the disposition rules would apply to a partial disposition of an asset. This would allow taxpayers to claim a loss upon the disposition of a structural component (or a portion thereof) of a building or a component (or a portion thereof) of any other asset without identifying the component as an asset before the disposition event. Further, the rule would minimize instances in which an original part and any subsequent replacement(s) of the same part would be required to be capitalized and depreciated simultaneously.

The partial disposition rule generally would be elective except in the following cases in which the rule would have to be applied:

- the disposition of a portion of an asset resulting from a casualty event described in Section 165,
- the disposition of a portion of an asset for which gain -- determined without regard to Sections 1245 or 1250 -- is not recognized in whole or in part under Sections 1031 or 1033,
- the transfer of a portion of an asset in a step-in-the-shoes transaction described in Section 168(i)(7)(B), or
- the sale of a portion of an asset.

A taxpayer could elect to apply the partial disposition rule on an asset-by-

asset basis on the timely filed original federal tax return, including extensions, for the tax year in which the portion of the asset is disposed. The annual binding election could be made for the current-year dispositions of any type of MACRS property, including assets in asset classes 00.11 through 00.4 of Rev. Proc. 87-56.

Except as discussed below, the election could not be made by filing an application for a change in method of accounting. Similarly, a taxpayer that wants to revoke the election could not do so by requesting a change in method of accounting; rather, a taxpayer would have to file a request for a letter ruling to revoke the election.

**Observation:** A taxpayer making a partial disposition election for an asset under asset classes 00.11 through 00.4 of Rev. Proc. 87-56 would have to classify the replacement portion of the asset under the same asset class as that of the disposed portion of the asset.

The 2013 proposed regulations also provide a special partial disposition rule that would apply if the IRS disallows a taxpayer's characterization of the replacement of a portion of an asset as a deductible repair and proposes an adjustment to capitalize such replacement cost. In that case, the taxpayer would have the option to make the partial disposition election by filing an application for change in accounting method, provided the asset to which the disposed portion related to is owned by the taxpayer at the beginning of the year of change.

The 2013 proposed regulations provide that if a taxpayer disposes of a portion of an asset and the partial disposition rule applies to that disposition, the taxpayer would have to account for the disposed portion in a single-asset account beginning in the tax year in which the disposition occurs.

The partial disposition election is illustrated in example 3 of the 2013 proposed regulations. In this example, the partial disposition election is made for an elevator that was replaced in an office building. Although the office building -- including its structural components -- is the asset for disposition purposes, the result of making the partial disposition election for the elevator is that the retirement of the replaced elevator is a disposition. As a result, depreciation for the retired elevator ceases at the time of its retirement (taking into account the applicable convention), and the taxpayer recognizes a loss upon the retirement. Further, the taxpayer must capitalize the amount paid for the replacement elevator, and the replacement elevator is a separate asset for disposition purposes.

#### Assets included in a GAA

The disposition rules also apply to a partial disposition of an asset included in a GAA in the following transactions:

- a casualty event described in Section 165,
- a disposition of a portion of an asset for which gain -- determined without regard to Sections 1245 or 1250 -- is not recognized in whole or in part under Sections 1031 or 1033,
- a transfer of a portion of an asset in a step-in-the-shoes transaction described in Section 168(i)(7)(B),
- the sale of a portion of an asset, or
- a disposition of a portion of an asset in a transaction described under the anti-abuse rules applicable to general accounts.

For transactions not listed above, a disposition of only a portion of an asset is made by electing to terminate the GAA upon the disposition of all

assets (including the disposed portion) in that GAA or by making a qualifying disposition election, if applicable (see discussion below), for the disposed portion.

**Observation:** As noted above, the partial disposition rules would apply to assets in a GAA for certain transactions. However, assets that do not fall under these transactions would not be afforded the flexibility of making a partial disposition election. These assets therefore would remain in the GAA until all assets or the last asset is disposed of, unless the restrictive qualifying disposition rules apply.

#### Identification of asset disposed

In general, the 2013 proposed regulations provide that taxpayers would have to use the specific identification method of accounting to identify the placed-in-service date for the asset disposed of. If it is impracticable for taxpayers to determine the tax year in which the asset was placed in service -- including situations in which the partial disposition rule applies -- the 2013 proposed regulations provide that a taxpayer would be allowed to use the following reasonable methods for identifying the placed-in-service year:

- First-in, first out (FIFO);
- A modified FIFO method;
- A mortality dispersion table if the asset disposed of is a mass asset grouped in a general asset account with other mass assets; or
- Any method designated by the IRS.

For assets included in a GAA, taxpayers would not have to use the specific identification method as a first choice and could use any of the reasonable methods (including the specific identification method) listed

above in identifying the placed-in-service year.

The last-in, first-out (LIFO) method specifically would not be permitted.

### *Qualifying dispositions for assets included in GAAs*

The 2011 temporary regulations allow taxpayers to elect to terminate GAA treatment for an asset in a GAA when the taxpayer disposes of the asset in a “qualifying disposition,” which those regulations define to include most dispositions. The 2013 proposed regulations would change the definition of a qualifying disposition back to the more restrictive rules under Reg. sec. 1.168(i)-1, the final regulations for GAAs, as in effect before the 2011 temporary regulations.

Accordingly, a qualifying disposition would be defined as a disposition that does not involve all the assets, the last asset, or the remaining portion of the last asset remaining in a GAA and that is:

- a direct result of a fire, storm, shipwreck, or other casualty, or from theft;
- a charitable contribution for which a deduction is allowable under Section 170;
- a direct result of a cessation, termination, or disposition of a business, manufacturing, or other income-producing process, operation, facility, plant, or other unit (other than by transfer to a supplies, scrap, or similar account); or
- generally a transaction to which a nonrecognition section of the Code applies.

**Observation:** Given the restrictive nature of the definition of qualifying dispositions under the 2013 proposed regulations, taxpayers likely would not

want to make GAA elections going forward except when the GAA would reduce administrative burdens.

**Observation:** In light of the simplified disposition rules provided in the 2013 proposed regulations, a taxpayer that made a retroactive GAA election for pre-2012 years under Rev. Proc. 2012-20, or made a GAA election on its 2012 federal income tax return may seek to revoke such elections and instead account for its dispositions under the 2013 proposed regulations. Although it is unclear whether the IRS would permit a taxpayer to revoke such elections, the forthcoming revenue procedures to implement the final and proposed regulations should provide clarity on whether the IRS would permit such a revocation and -- if such revocations are permitted -- how such revocations could be made.

### *Determination of basis for asset*

The 2011 temporary regulations provide for the use of any reasonable, consistent method in situations in which the determination of the unadjusted depreciable basis of an asset may be impracticable because the asset is in a GAA, in a MAA, or is a component of a larger asset. The 2013 proposed regulations would clarify a reasonable, consistent method by providing nonexclusive examples that include:

- discounting the cost of the replacement asset to its placed-in-service year cost using the Consumer Price Index;
- a pro-rata allocation of the unadjusted basis of the GAA or MAA, as applicable, based on the replacement cost of the disposed asset and the replacement cost of all the assets in the GAA or MAA, as applicable; and
- a study allocating the cost of the asset to its individual components.

The above examples also would apply to situations in which the partial disposition rules apply. That is, taxpayers could use any reasonable method for determining the unadjusted depreciable basis of the disposed portion of the asset or of each disposed portion of the same asset (disposals of more than one portion of the same asset).

**Observation:** The preamble to the 2013 proposed regulations notes that the IRS expects that reasonable methods are available that use information readily available and known to the taxpayer.

### *Rentals and leased property*

Reg. sec. 1.162-11(b) provides that the cost incurred by a lessee to erect buildings or make permanent improvements on leased property is a capital expenditure and is not deductible as a business expense. Reg. sec. 1.167(a)-4 provides that capital expenditures made by either a lessee or lessor to leased property are recovered under the applicable provisions of the Code -- such as Sections 167 or 168 -- without regard to the term of the lease.

**Observation:** In general, changes to Reg. sec. 1.162-11 and Reg. sec. 1.167(a)-4 conform these regulations to changes made to the Code in 1986. Since 1986, these costs have been recoverable under the applicable cost recovery provisions of the Code without regard to the length of the lease. Likewise, the changes to these regulations do not change the manner in which costs to acquire a leasehold interest are recovered. Accordingly, such costs continue to be recovered ratably over the applicable term of the lease. The changes discussed above for rentals and leased property have not been modified by the 2013 proposed regulations.



### **Removal costs**

The final repair regulations provide a specific rule clarifying the treatment of removal costs. The 2011 temporary regulations addressed component removal costs as an example of a type of indirect cost that must be capitalized if the removal costs directly benefit or are incurred by reason of an improvement. The final repair regulations state that if a taxpayer disposes of a depreciable asset for federal tax purposes and has taken into account the adjusted basis of the asset or component of the asset in realizing gain or loss, then the costs of removing the asset or component are not required to be capitalized under Section 263(a).

Moreover, if a taxpayer disposes of a component of a UOP and the disposal is not a disposition for federal tax purposes, the taxpayer must deduct or capitalize the costs of removing the component based on whether the removal costs directly benefit or are incurred by reason of a repair to the UOP or an improvement to the UOP.

**Observation:** The preamble to the 2011 temporary regulations indicated that the temporary regulations were not intended to affect the holding of Rev. Rul. 2000-7 as it applied to the cost of removing an entire UOP. Although the language in the preamble was supported by the holding in Rev. Rul. 2000-7, the 2011 temporary regulations did not explicitly state that the costs incurred to remove an entire UOP were not required to be capitalized. The final repair regulations attempt to clarify the 2011 temporary regulations with

respect to costs incurred to remove an entire UOP and remain consistent with the principles of Rev. Rul. 2000-7.

### ***The takeaway***

The 2013 proposed regulations retain many of the provisions in the 2011 proposed and temporary regulations. However, the 2013 proposed regulations would provide significant changes to the rules relating to the determination of the asset disposed of and a qualifying disposition of an asset in a GAA, along with new rules for partial dispositions of assets. The significant changes in the 2013 proposed regulations would provide taxpayers with simpler rules in implementing these regulations.

The definition of asset disposed of for tax purposes in the 2013 proposed regulations would be changed back to prior law to include the building and its structural components. The definition of a disposition would be expanded to include partial dispositions of MACRS property such as the retirement of a structural component, provided that the partial disposition election is made. The partial disposition rule would be implemented with a binding annual election on an asset-by-asset basis on the timely filed original federal tax return, including extensions, for the tax year in which the portion of the asset is disposed.

Another significant change in the 2013 proposed regulations relates to the definition of a qualifying disposition for GAAs. The 2013 proposed regulations would change the

definition of a qualifying disposition back to the more restrictive rules under Reg. sec. 1.168(i)-1, the final regulations for GAAs, as in effect before the 2011 temporary regulations. Taxpayers that did not use GAAs prior to the 2011 temporary regulations therefore likely would not want to make GAA elections going forward.

The forthcoming revenue procedures should provide taxpayers with clarity on the ability to revoke prior GAA elections made for pre-2012 or post-2012 tax years. The IRS stated in the preamble to the 2013 proposed regulations its plan to finalize these regulations in 2013 with application to tax years beginning on or after January 1, 2014. If the 2013 proposed regulations are not finalized until 2014, taxpayers should be aware of the possibility that the final regulations for dispositions could be applied retroactively to tax years beginning on or after January 1, 2014.

Comments on the 2013 proposed regulations are being accepted until November 12, 2013.

On October 9, 2013, PwC hosted an in-depth webcast to analyze the impact of the final repair regulations and proposed disposition regulations.

A link to the archived replay can be found here:

<http://event.on24.com/eventRegistration/prereg/register.jsp?eventid=688567&sessionid=1&key=10B22BFDF14B36E66B2BE404853A4A31>

## ***Let's talk***

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