

# The Final Disposition Regulations

The final regulations regarding dispositions of property subject to depreciation under § 168 of the Internal Revenue Code became effective on August 18, 2014, and apply to taxable years beginning on or after January 1, 2014. The final regulations provide rules for determining gain or loss upon the disposition of MACRS property, determining the asset disposed of, and accounting for partial dispositions of MACRS property.

## What Is A Disposition?

A disposition occurs when ownership of the asset is transferred or when the asset is permanently withdrawn from use either in the taxpayer's trade or business or in the production of income. A disposition includes the sale, exchange, retirement, physical abandonment, or destruction of an asset. A disposition also includes the retirement of a structural component (or a portion thereof) of a building only if the partial disposition rule applies to such structural component (or a portion thereof).

## What Was Disposed Of?

In general, the facts and circumstances of each disposition are considered in determining the appropriate disposed asset. However, the asset for tax disposition purposes may not consist of items placed in service by the taxpayer on different dates. Further, the unit of property as determined under § 1.263(a)-3(e) or in published guidance in the Internal Revenue Bulletin under § 263(a) does not apply for purposes of determining what is the appropriate disposed asset.

Additionally, the final regulations provide special rules for certain types of properties. For example, each building (including its structural components) is the asset for tax disposition purposes. If there is an improvement or addition to an existing building (including its structural components), the improvement or addition is the asset. If a building includes two or more condominium or cooperative units, each condominium or cooperative unit (including its structural components) is the asset.

The final regulations also provide that if a taxpayer properly includes an item in one of the asset classes 00.11 through 00.4 of Rev. Proc. 87-56 (1987-2 CB 674) or classifies an item in one of the categories under § 168(e)(3) (other than a category that includes buildings or structural components; for example, retail motor fuels outlet and qualified leasehold improvement property), each item is the asset provided it is not an improvement or addition to an existing asset.

Finally, and consistent with § 168(i)(6), the final regulations provide that if the taxpayer places in service an improvement or addition to an asset after the taxpayer placed the asset in service, the improvement or addition is a separate asset.

## Partial Dispositions

The partial disposition rule allows taxpayers to claim a loss upon the disposition of a structural component (or a portion thereof) of a building or upon the disposition of a component (or a portion thereof) of any other asset without identifying the component as an asset before the disposition event. The partial disposition rule also minimizes circumstances in which an original part and any subsequent replacements of the same part are required to be capitalized and depreciated simultaneously.

The partial disposition rule is required to be applied to a disposition of a portion of an asset as a result of a casualty event described in § 165, to a disposition of a portion of an asset for which gain (determined without regard to §§ 1245 or 1250) is not recognized in whole or in part under §§ 1031 or 1033, to a transfer of a portion of an asset in a step-in-the-shoes transaction described in § 168(i)(7)(B), or to a sale of a portion of an asset. Consequently, a disposition includes a disposition of a portion of an asset under these circumstances, even if the taxpayer does not make the partial disposition election for that disposed portion. For other transactions, a disposition includes a disposition of a portion of an asset only if the taxpayer makes the partial disposition election for that disposed portion.

The partial disposition election is made on the taxpayer's timely filed original Federal tax return, including extensions, for the taxable year in which the portion of the asset is disposed of by the taxpayer. This election may not be made or revoked by the filing of an application for a change in method of accounting.

**Example 1:** D owns a retail building. D replaces 60% of the roof of this building. In accordance with paragraph 1.168(i)-8(c)(4)(ii)(A), the retail building, including its structural components, is the asset for disposition purposes. Assume D must capitalize the costs incurred for replacing 60% of the roof pursuant to § 1.263(a)-3(k)(1)(vi). D makes the partial disposition election provided under paragraph 1.168(i)-8(d)(2) for the 60% of the replaced roof. Thus, the retirement of 60% of the roof is a disposition. As a result, depreciation for 60% of the roof ceases at the time of its retirement, taking into account the applicable convention, and D recognizes a loss upon this retirement. Further, D must capitalize the amount paid for the 60% of the roof pursuant to § 1.263(a)-3(k)(1)(i) and (vi) and the replacement 60% of the roof is a separate asset for disposition purposes pursuant to paragraph 1.168(i)-8(c)(4)(ii)(D) and for depreciation purposes pursuant to § 168(i)(6).

**Example 2:** D owns a retail pad site. D replaces 40% of the structural components (as defined under 1.48-1(e)(2)) of this building. In accordance with paragraph 1.168(i)-8(c)(4)(ii)(A), the entire building, including its structural components, is the asset for disposition purposes. Assume D must capitalize the costs incurred for replacing 40% of the structural components pursuant to § 1.263(a)-3(k)(1)(vi) and (k)(6). D makes the partial disposition election provided under paragraph 1.168(i)-8(d)(2) for the 40% of the replaced structural components. Thus, the retirement of 40% of the structural components is a disposition. As a result, depreciation for 40% of the structural components ceases at the time of their retirement, taking into account the applicable convention, and D recognizes a loss upon this retirement. Further, D must capitalize the amount paid for the 40% of the structural components pursuant to § 1.263(a)-3(k)(1)(i) and (vi) and the replacement 40% of the structural components are separate assets for disposition purposes pursuant to paragraph 1.168(i)-8(c)(4)(ii)(D) and for depreciation purposes pursuant to § 168(i)(6).

## Calculating Gain or Loss

If an asset is disposed of by sale, exchange, or involuntary conversion, gain or loss is recognized under the applicable provisions of the Code. If an asset is disposed of by physical abandonment, loss is recognized in the amount of the asset's adjusted depreciable basis at the time of the abandonment, unless an abandoned asset is subject to nonrecourse indebtedness in which case the asset is treated in the same manner as an asset disposed of by sale. Finally, if an asset is disposed of other than by sale, exchange, involuntary conversion, physical abandonment, or conversion to personal use (for example, when the asset is transferred to a supplies or scrap account), gain is not recognized but loss is recognized in the amount of the excess of the asset's adjusted depreciable basis over its fair market value at the time of disposition. The same rules apply when the partial disposition rule applies to a disposition of a portion of an asset.

## Be Aware of §280B

§ 280B requires that if a building is demolished, the removal costs, as well as any loss sustained on account of the demolition (e.g., the remaining adjusted basis of the building), must be capitalized to the related land account. However, the coordination of this section with the new regulations is unresolved at this time. While it seems clear that § 280B still applies to a complete demolition of a building (see §§ 1.263(a)-3(g)(2)(i) & 1.168(i)-8(e)), its application to partial dispositions is less certain. It should be noted that "demolition" is not defined in the statute or the implementing regulation (see § 1.280B-1), but Rev. Proc. 95-27 provides a safe harbor if (1) 75% or more of the existing external walls of the building are retained in place as internal or external walls, **and** (2) 75% or more of the existing internal structural framework of the building is retained in place.

Note that the safe harbor refers to the "internal structural framework" of the building, defined at § 1.48-12(b)(3)(iii) as "all loadbearing internal walls and any other internal structural supports, including the columns, girders, beams, trusses, spandrels, and all other members that are essential to the stability of the building." This definition is much narrower than that for "structural components" found under § 1.48-1(e)(2), and referenced at § 1.263(a)-3(e)(2) (the unit of property rules for improvements). Therefore, a taxpayer will be able to make partial dispositions that exceed 25% of the structural components (e.g., fixtures, flooring, plumbing, & electrical) without having to recapitalize the remaining basis to a land account.

## About Scarpello Consulting

Launched in 2001, Scarpello Consulting provides cost segregation consulting services to help clients maximize their depreciation allowances while minimizing audit risk. The firm has four locations including Los Angeles, CA; Omaha, NE; Overland Park, KS; and New York, NY. Additional information is available at <http://www.ScarpelloConsulting.com> or (877) 410-5040.