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Company of the Month: MS Consultants discusses final tangible property regulations and cost segregation studies

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After approximately 10 years of proposed and temporary regulations, the IRS issued the final tangible property regulations that deal with which taxpayer expenditures can be expensed as repairs and maintenance in the year the expenditure is made, and which expenditures are required to be capitalized.

Beginning in 2014, all taxpayers were required to adopt the new tangible property regulations. The new regulations are long, complex, and confusing, and will impact almost all taxpayers. In many instances, more expenditures are required to be capitalized and depreciated over IRS prescribed asset class lives than in the past. Many expenditures that taxpayers previously deducted as repairs and maintenance will now be required to be capitalized.

However, the new rules may provide taxpayers with opportunities to increase their tax deductions on their 2014 tax returns. Some of these opportunities are only available for tax years beginning in 2014, so as the saying goes, opportunity knocks but once. In order to capture the increased deductions, taxpayers will need to potentially file multiple complex elections and IRS forms. If taxpayers have extended their 2014 tax returns they can still take advantage of many of the provisions. Even if taxpayers have filed their 2014 income tax returns, the IRS will allow taxpayers to amend their returns to take advantage of the regulations.

One of the most significant opportunities available under these new regulations is the opportunity to write-off structural components that may have been replaced in the past, but are still on the depreciation records and being depreciated. For example under the old regulations if a taxpayer replaced a roof they would have been required to capitalize the new roof and depreciate both roofs. The opportunity to write-off prior year replaced structural components expires after the filing of your 2014 tax returns.

The Internal Revenue Service is giving taxpayers a one year window to "scrub" their depreciation schedules and remove any assets that no longer physically exist. While in many situations a loss on disposal will result, taxpayers should also write-off fully depreciated assets that no longer exist to avoid depreciation recapture in the future. In most instances taxpayers will need to have a cost segregation study performed to determine the net tax value of the assets removed.

This is where the marriage comes in. A cost segregation study allocates various classes of assets to their proper depreciable lives which are required by the IRS. Without a cost segregation study, all assets in a commercial building are required to be written off over 39 years, or in the case of residential property, over 27.5 years. A cost segregation study allocates assets to various depreciable lives generally ranging from 5 to 39 years. This allows a taxpayer to take increased depreciation over a shorter number of years for a portion of the building costs. The increased depreciation allows for larger tax deductions and fewer taxes paid, thereby increasing cash flow in the early years of a project. And of course, most developers want the cash to acquire another project.

Another benefit of a cost segregation study is the cost breakout it provides for structural components of a building that are required to be depreciated over 39 or 27.5 years. Since a cost segregation study has hundreds or thousands of line items, when assets are replaced, a taxpayer can write-off the net tax value of the replaced asset. In many instances when a taxpayer acquires a property the building is input on the deprecation schedule in one lump sum amount and depreciates over 39 or 27.5 years. This creates a dilemma in future years when new windows need to be installed and the taxpayer is unable to identify the cost of the original windows. The great news is that the IRS will allow you to go back in time and perform a cost segregation study to identify the original cost of the windows so they can be written-off, most likely resulting in a deductible loss on the taxpayer's income tax returns. Even greater news is that the IRS will allow a taxpayer to go back in time and put the assets in the correct asset life, typically resulting in additional depreciation deductions in the year a taxpayer decides to have the cost segregation study performed.

In addition to the above, the new regulations allow taxpayers to make annual elections on their income tax returns allowing them to deduct in the year the expenditure was made, expenditures that would otherwise need to be capitalized. There are two elections that many taxpayers will find beneficial. The good news is that the annual elections do not have an expiration date.

The first election is the De minimis election that allows taxpayers to deduct (in the year an expenditure is made) any expenditure below a prescribed dollar limit up to $5,000. Most taxpayers will have a $500 limit and the taxpayer must have a consistent asset capitalization policy for tax and financial statement purposes. This election does not apply to certain expenditures relating to inventory or land acquisition. If a taxpayer acquires 200 refrigerators at $499 apiece and has a capitalization policy in place of $500, the taxpayer may deduct the cost of the refrigerators ($99,800) in the year acquired as opposed to the five year recovery period if they were required to be capitalized.

The second election is the Small Taxpayer Safe Harbor that allows taxpayers with average yearly gross receipts less than $10 million, and buildings with a tax basis less than $1 million, to expense on a yearly basis, the lesser of $10,000 or 2% of the buildings' tax basis expenditures that might otherwise need to be capitalized and written-off over the expenditures' applicable IRS tax life.

The above provisions represent only a portion of the required elections and filings, though they are the provisions that will impact the majority of taxpayers. 2015 will be a busy year for taxpayers and their tax advisors.

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