

KBKG TAX INSIGHT: IRS TO INCREASE SCRUTINY OF BUILDING PARTIAL DISPOSITIONS, PROVIDES GUIDANCE TO FIELD AGENTS

[As featured in Accounting Today](#)

The IRS is concerned that taxpayers are not properly recognizing the gain or loss on partial dispositions of building components.

As a result of the disposition regulations that were finalized in 2014, taxpayers are able to claim a partial disposition of a building component and recognize a loss on their tax return in the year of disposition. The partial disposition election is one of five issues targeted by the IRS Large Business and International division for its audit strategy. Recently, the IRS released an LB&I “Process Unit” to guide its auditors when examining a taxpayer that elected to recognize a partial disposition of a building under Treas. Reg. 1.168(i)-8(b)(2). This guidance emphasizes the need for proper substantiation to support partial dispositions.

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KBKG INSIGHT

The IRS is concerned that taxpayers are not properly recognizing the gain or loss on partial dispositions of building components. A newly created IRS Process Unit to assist agents on how to examine a partial disposition of a building spotlights the need for taxpayers to make sure they are doing it right!

The IRS Process Unit concentrates on five steps for examining a taxpayer who has elected a partial disposition of a building component. Generally, a disposition occurs when ownership of an asset is transferred or when the asset is permanently withdrawn from use in the taxpayer's trade or business or income producing activity. Taxpayers may make an annual partial disposition election for any portion of a building in tax years beginning on or after January 1, 2014. Electing a partial disposition of a building will generally result in a loss recognized on the tax return in the year of disposition. The election must be made on a timely-filed original tax return, including extensions, for the year in which the taxpayers disposes of a portion of the building.

According to the Process Unit, once an examiner has determined there is a risk that the taxpayer didn't comply with the rule for reporting a partial disposition of a building (or its structural components), the agent should follow the following five examination steps:

Step 1 – Determine If Partial Disposition of a Building Occurred

The examiner should confirm whether the taxpayer has maintained records for its depreciable assets in accordance with Treas. Reg. 1.167(a)-7(c). The taxpayer has the burden of proof to substantiate that a partial disposition of a building or its structural components occurred. The examiner should ask the taxpayer how they determined whether a partial disposition occurred. If the taxpayer can't substantiate that a disposition occurred, the Process Unit recommends that the examiner disallow the partial disposition.

Step 2 – Identify the Disposed Portion of the Building

A taxpayer's books and records must be used to substantiate the identity of the portion of the building or the structural component disposed. The examiner should review the taxpayer's books and records to determine whether they provide enough information to identify the portion of the building or its structural components disposed. The examiner should also verify that the taxpayer has a depreciable interest in the property. If the disposed portion cannot be identified from the taxpayer's books and records, then the taxpayer cannot recognize the partial disposition. The examiner should disallow the partial disposition, adjust for the gain or loss recognized, and adjust the basis of the respective asset(s).

Step 3 – Identify Partially Disposed Asset and PIS Date

Identifying which asset is partially disposed of and its PIS date begins with the taxpayer's books and records. The disposition regulations provide that, generally, the specific identification method of accounting must be used by a taxpayer to identify the asset in the case of the disposition of an entire asset or a portion of an asset. Under the specific identification method, the taxpayer can determine the particular taxable year the disposed asset (or partially-disposed asset) was PIS. However, it may be impracticable from the taxpayer's records to specifically determine the PIS date of an asset when there is a disposition of a portion of the asset that has been replaced multiple times over the years. When it is impracticable to specifically identify the partially-disposed asset in the taxpayer's books and records, the disposition regulations provide for simplified methods to be used to identify the partially-disposed asset: First-In-First-Out (FIFO); Modified FIFO; or a mortality dispersion table, if the asset is a mass asset; or any other method the Secretary may designate by publication. The taxpayer cannot recognize the partial disposition if:

- The taxpayer has not been able to substantiate the identity of the asset partially disposed of, or
- The disposed asset and replacement asset

do not meet the criteria of same type, recovery period, and location, or

- The disposed asset was pre-MACRS or is a zero-basis asset.

Step 4 – Determine Disposed Portion’s Adjusted Basis

According to the Process Unit, the examiner’s starting point for determining the adjusted basis of the disposed of portion of a building is the unadjusted basis of the entire building. Once the unadjusted basis of the entire building is determined, then the adjusted basis of the disposed of portion can be computed. The examiner should remember to account for any additional first-year depreciation that is attributable to the disposed portion of the building. The examiner should disallow the partial disposition, adjust the gain or loss recognized, and adjust the basis of the respective disposed asset(s) if the taxpayer:

- Has not been able to substantiate that a reasonable method was used to determine the adjusted depreciable basis of the partially-disposed asset, or
- Has calculated the adjusted depreciable basis in error, or
- Has otherwise overstated the loss or understated the gain on the partial disposition.

Step 5 – Reduce Adjusted Basis of the Asset

The remaining asset must have its depreciation reserve (accumulated depreciation) reduced by the amount of depreciation allowed on the portion of the asset disposed of so that the remaining asset reflects its remaining adjusted depreciable basis. If the taxpayer has not accounted for the partial disposition accurately on its books and records, the examiner should adjust the basis of the respective assets and adjust the depreciation expense, if needed.

Substantiating Partial Dispositions

Taxpayers may know they have a partial disposition and yet struggle with the calculations supporting steps 3 through 5 from the Process Unit above.



However, there are two tools that may prove helpful in these situations. First, a proper cost segregation study will identify the various MACRS recovery periods found in a building, the eight specific building systems prescribed by the Tangible Property Regulations, and other primary components that may be disposed and replaced in future years. Therefore, cost segregation studies can provide essential data needed to perform a partial disposition calculation and may be very useful for years to come as improvements continue to be made to the building.

Second, in those situations where no cost segregation study is available, there is a practical way to estimate the unadjusted depreciable basis of a building component that has been disposed from the cost of the replacement asset as long as the replacement is considered to be a restoration. It involves using an IRS recommended discounting methodology based on the Producer Price Index (PPI), as per T.D. 9689 (Guidance Regarding Dispositions of Tangible Depreciable Property).

KBKG's Online Partial Disposition Calculator

KBKG has developed an online partial disposition calculator using this PPI discounting methodology because of the difficulty in determining the tax basis of each component when a cost segregation study is not available. It's designed to be a turnkey solution allowing tax preparers to estimate the unadjusted depreciable basis of a building component that has been disposed in order to claim a partial disposition deduction.

KBKG's calculator takes the "replacement cost" of the new component and discounts it back to the place-in service date of the original disposed component. The calculator accounts for the condition of the asset (at the time it was acquired), which is based on effective age and normal life. Remember, the PPI approach is only applicable for improvements deemed as "restorations". If the improvement is a "betterment" or an "adaptation", please contact KBKG to assist with determining the partial disposition basis using engineering and estimation principles.



Partial dispositions are generally beneficial to taxpayers and in some cases are required. It's important that taxpayers properly calculate and substantiate these dispositions that must be recognized on a timely filed tax return.

Authors: Eddie Price, CCSP & Harry Sahi

Contact us today to find out how KBKG's Online Partial Disposition Calculator can help you.