LB&I Process Unit

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Knowledge Base: Deductible and Capital Expenditures

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Process Overview

Note: This Practice Unit updates the 10/29/19 Practice Unit with the same title. Formatting changes were made to improve content presentation. No substantive changes were made to the technical content.

This Practice Unit concentrates on the five steps involved in examining a taxpayer who has elected a partial disposition of a building or its structural components. This Process Unit will assist you, the examiner, in verifying a taxpayer's compliance with the IRC 168 disposition regulations.

In order to comply with the disposition regulations, a taxpayer must be able to substantiate that it:

1. Disposed of a portion of a building or its structural components,
2. Identified the disposed portion of a building or its structural components,
3. Identified which asset was partially disposed of and its placed-in-service (PIS) date,
4. Determined the adjusted basis of the disposed portion, and
5. Reduced the adjusted basis of the asset by the disposed portion.

These are the five steps outlined in this Practice Unit and illustrate the importance of taxpayer records in applying the IRC 168 disposition regulations. The disposition regulations do not change a taxpayer's record keeping requirement. Under Treas. Reg. 1.168(i)-7(d), taxpayers must continue to maintain records as required in Treas. Reg. 1.167(a)-7(c).

Taxpayers may make an annual partial disposition election to recognize the disposition of a portion of a building, including its structural components, in tax years beginning on or after January 1, 2014. Any taxpayer having a depreciable interest in a building or its structural components may make the election. Electing a partial disposition of a building will generally result in a loss recognized on the tax return in the year of disposition.

Taxpayers are required to recognize a partial disposition in the following instances:

- A casualty event under IRC 165;
- A disposition portion of an asset for which gain is not recognized, in whole or in part, under IRC 1031 or 1033;
- Transfers of a portion of an asset in a "step-in-the-shoes" transaction in IRC 168(i)(7)(B); or
- Sales of a portion of an asset.

Detailed Explanation of the Process

You will need to review the taxpayer's records and methodology in determining the accuracy of the taxpayer's calculation of gain or loss recognized on the partial disposition of a building or its structural components. Taxpayers may be claiming erroneous gains or losses on the partial disposition of a building or its structural components. The errors can result in overstated depreciation, overstated loss or understated gain on the disposition, or duplicated basis in the partially-disposed asset. See Identifying a Taxpayer Electing a Partial Disposition of a Building Practice Unit for additional information.

Background and Information

Taxpayers can recognize the partial disposition of a building, including its structural components, for tax years beginning on or after January 1, 2014. Prior to the disposition regulations, taxpayers were prohibited from recognizing the partial disposition of any asset (such as a building, including its structural components). For example, a taxpayer could not recognize a loss when an old roof was disposed of and replaced with a new roof.

The Modified Accelerated Cost Recovery System (MACRS) disposition regulations,[1] provide rules for recognizing gain or loss on the disposition of MACRS property. Treas. Reg. 1.168(i)8(d)(2) allows taxpayers to elect to recognize partial dispositions of MACRS property, including the disposition of a portion of a building or its structural components. The partial disposition election is an annual election for tax years beginning on or after January 1, 2014. The election is made by reporting the gain or loss on a timely-filed original tax return, including extensions, for the taxable year in which the portion of the building is disposed. No specific form or election statement is required to be attached to the return.

Taxpayer Records, Simplified Methods and Specific Identification

The disposition regulations have not changed a taxpayer's burden to maintain records on depreciable property. Treas. Reg. 1.168(i)7(d) of the disposition regulations provides that taxpayers must continue to maintain records as required in Treas. Reg. 1.167(a)-7(c). Because taxpayers could not recognize partial dispositions of assets before the 2014 MACRS disposition regulations, they were not required to keep records on PORTIONS of buildings. The disposition regulations recognize this and provide:

- Simplified methods to identify the PIS date of the asset when a portion of the asset is disposed of, and the taxpayer is unable to specifically identify the asset using its records, and
- Examples of reasonable methods, where needed, to allow taxpayers to calculate the unadjusted basis of the disposed portion of the building.

The simplified or reasonable methods provided in the regulations can be applied in calculating the gain or loss on the partial disposition.

Taxpayers must use the records required by Treas. Reg. 1.167(a)-7(c) as the starting point for any partial gain or loss calculated. The simplified methods and examples of reasonable methods contained in the IRC 168 disposition regulations are used to supplement these records.

The regulations do not provide simplified methods for:

- Determining whether a partial disposition of a MACRS asset occurred,
- What portion of the asset was disposed of, or
- Whether the taxpayer held a depreciable interest in the asset.

Under the disposition regulations, each building, including its structural components, is an asset. An improvement or addition to a building, including its structural components, is a separate asset from the building, if it is PIS after the original asset.

The regulations require the specific identification method for identifying partially-disposed assets accounted for in Single Asset Accounts (SAAs) in the taxpayer's books and records. The specific identification method is also required to identify the partially-disposed assets accounted for in Multiple Asset Accounts (MAAs), unless it is "impracticable" for the taxpayer to use specific identification.

- While the regulations do not define the term "impracticable," the term should be considered in light of the taxpayer's existing responsibility to maintain its records as set forth in Treas. Reg. 1.167(a)-7(c). In other words, the taxpayer cannot use the simplified methods provided in the regulations, and discussed later in Step 3, if they lack the records required under Treas. Reg. 1.167(a)7(c).
- Merriam-Webster Dictionary defines impracticable as "incapable of being performed or accomplished by the means employed or at command."

If the records required under Treas. Reg. 1.167(a)-7(c) do not exist, this may indicate larger problems with the taxpayer's accounting systems and you must consider the extent to which, if at all, the taxpayer can identify the portion of the building that was disposed of and establish its adjusted basis.

Five Steps

If after you have determined there is a risk of noncompliance of a taxpayer in recognizing the partial disposition of a building or its structural components, you will walk through five steps in the examination of the issue. The five steps will assist you in using the taxpayer's records to assess the amount of gain or loss recognized on the partial disposition.

Step 1 – Determine Whether a Partial Disposition of a Building Occurred

Step 2 – Identify the Disposed Portion of the Building

Step 3 – Identify Which Asset is Partially Disposed of and Its Placed-in-Service Date

Step 4 – Determine the Adjusted Basis of the Disposed Portion of the Asset

Step 5 – Account for the Disposed Portion -Reduce the Adjusted Basis of the Asset by the Disposed Portion

Process Steps

Examination has determined that there is a compliance risk on the taxpayer's partial disposition of a building (or its structural components) under the IRC 168 disposition regulations. A review of the taxpayer's records and methodology is needed in assessing the accuracy of the taxpayer's calculation of the gain or loss recognized on the partial disposition. You will walk through five steps in its issue development.

Step 1: Determine If Partial Disposition Occurred

Determine whether a partial disposition of a building occurred.[2]

Considerations

When determining whether a partial disposition of a building or its structural components occurred, it is important to understand the taxpayer's record-keeping requirements, dispositions in general, the connection the disposition regulations have with the Tangible Property Regulations (TPR), and instances when a partial disposition is required.

In General -Record-Keeping Requirements

Confirm whether the taxpayer has maintained records for its depreciable assets in accordance with Treas. Reg. 1.167(a)-7(c).[3] The following requirements are stated in the Regulations:

- Records for depreciable property are maintained by account. Under Treas. Reg. 1.168(i)7, taxpayers may maintain accounts containing a single asset in a SAA or assets can be pooled together in a MAA. A taxpayer may have as many or as few accounts as it chooses.
- Separate depreciation reserves for each account, where reserves are maintained.
- Book of accounts or permanent auxiliary records showing, for each account, the basis of property and any adjustments to basis.
  - Under the disposition regulations, each building, including its structural components, is the asset. Improvements and additions to the building or its structural components are separate assets from the building, if they are PIS after the original asset.

- Permanent auxiliary records showing the differences in depreciation for tax and book purposes.
  - This includes, for example, any adjustment to the depreciable basis of assets from prior elections, taxpayer-initiated changes in methods of accounting (CAMs)[4] or Service-initiated adjustments.

In General -Dispositions

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 includes the retirement of a structural component (or a portion thereof) of a building, if the partial disposition rule applies to such structural component (or a portion thereof). The partial disposition rule applies when a taxpayer makes a "partial disposition election" and must be applied when the partial disposition occurs by casualty under IRC 165, by like-kind exchange or involuntary conversion under IRC 1031 or 1033, by step-in-the-shoes transaction under IRC 168(i)(7)(B), or by sale of a portion of an asset.

A partial disposition cannot be recognized if:

- There is a demolition of a building under IRC 280B.
- The asset/building was not PIS prior to the partial disposition.
- The taxpayer does not have a depreciable interest in the portion of the building or structural component disposed of.
- The building or asset disposed of is a pre-MACRS asset (pre-1987 assets).

In General - TPR and Disposition Regulations

The TPR under Treas. Reg. 1.263(a)-3 provide rules for capitalizing improvements to buildings. The TPR and the disposition regulations under Treas. Reg. 1.168(i)-8 interact with each other. In some cases, the disposition of a portion of an asset will require capitalization of the replacement costs.

Treas. Reg. 1.263(a)-3(k) requires capitalization when a part or a combination of parts, that comprise a major component or substantial structural part of a Unit of Property (UOP), is replaced. Replacement costs must be capitalized regardless of the size or importance if:

- The taxpayer has properly deducted a loss for the replaced component;
- The taxpayer has properly considered the adjusted basis of the component in realizing gain or loss resulting from the sale or exchange of the replaced component; or

- A UOP is restored following a casualty loss/event under IRC 165. On the other hand, a taxpayer cannot assume that every project capitalized under IRC 263(a) or IRC 263A, as an “improvement” to the building or its structural components, results in a partial disposition under Treas. Reg. 1.168(i)-8.

On the other hand, a taxpayer cannot assume that every project capitalized under IRC 263(a) or IRC 263A, as an “improvement” to the building or its structural components, results in a partial disposition under Treas. Reg. 1.168(i)-8.

- Relying on capitalization does not substantiate that a disposition occurred.
- If the asset was not PIS prior to any improvement, a disposition under the disposition regulations cannot occur.
- If the building or its structural components is a pre-MACRS asset, there is no partial disposition under the disposition regulations.

Likewise, a taxpayer cannot assume that every capitalized “addition” to a building and its structural components corresponds with a partial disposition under Treas. Reg. 1.168(i)-8.

- An addition to a building does not substantiate that a disposition occurred.
- Generally, additions to a building will not result in the disposition of a portion of another asset or a portion of an asset.
- There may be circumstances when an addition would involve the disposition and replacement of a structural component of a building. For example, a taxpayer may replace the entire Heating, Ventilation, Air Conditioning (HVAC) system to accommodate a new building addition rather than just adding to the existing HVAC system.

Refer to IRC 263(a) for capitalization requirements.

In General - Required Partial Dispositions

There are instances when a partial disposition is required to be recognized:

- A casualty event described in IRC 165;
- A disposition of a portion of an asset for which gain is not recognized, in whole or in part, under IRCs 1031 or 1033.
- A transfer of a portion of an asset in a “step-in-the-shoes” transaction described in IRC 168(i)(7)(B); or
- A sale of a portion of an asset.

Books and Records

The taxpayer has the burden of proof to substantiate that a partial disposition of a building or its structural components occurred. You should consider the following to determine if the taxpayer is able to substantiate the occurrence of the disposition:

- Do the records include pre-MACRS assets (PIS pre-1987) or MACRS assets that have been fully depreciated (zero-basis assets)? Pre-MACRS assets are ineligible for the partial disposition election and zero-basis assets will result in no loss realized when they are partially disposed of.
- Request verification of any dispositions or demolitions of portions of buildings or structural components associated with capitalized improvements.
  - Review the dates of any building-related acquisitions, remodels or other improvements, including additions. Review the dates of any associated dispositions, including any demolitions of portions of the building or its structural components.
- Verify taxpayer has a depreciable interest in the building or structural component that was partially disposed of.
  - Identify buildings the taxpayer leased, where the taxpayer may not have a depreciable interest in the portion of the building disposed of during the taxpayer's improvement project.
- Consider whether the structural modifications to the building rise to the level of a demolition of a structure under IRC 280B. If so, a disposition cannot be recognized.
- Compare the building's acquisition date with its remodeling construction period and with its PIS date.
  - A partial disposition cannot occur before the building is PIS.
  - A building (or any asset) not PIS is not a MACRS asset and the disposition regulations are not applicable to non-MACRS assets.
    - For example, a taxpayer acquires a restaurant building on Date 1. The taxpayer remodels the building before placing it in service on Date 2 and begins using it for its intended purpose as a restaurant. The building is not MACRS property until it is PIS. The disposition regulations do not apply to any structural components disposed of before this building is PIS.
- Verify the year of the disposition.
  - Remodel projects may cross multiple years. Assume a remodel project begins after the building is PIS. Only the partial dispositions that occurred in the first tax year of the remodel are subject to the partial disposition election in the first tax year. Similarly, only the structural components disposed of in the second

tax year of the remodel are subject to the partial disposition election in the second tax year.

- Interview the taxpayer to determine if any “Required Partial Dispositions” occurred during the tax year (see In General – Required Partial Dispostions for list).
- Ask the taxpayer how they determined whether a partial disposition occurred.
  - Does the taxpayer have records to confirm that a disposition of a portion of a building or any of its structural components actually occurred?
  - Did the taxpayer assume that because an improvement was made to a building or any of its structural components that a portion of the building or structural component was disposed?
  - Did the taxpayer improperly use any of the simplified methods provided in the disposition regulations to assume that a partial disposition occurred? Simplified methods are discussed in Step 3.
  - Confirm whether the taxpayer distinguishes between “improvements” and “additions” in its books and records.
    - While an “improvement” to an existing building or structural component may involve the replacement of a portion of the building or structural component, an “addition” to an existing building or structural component will generally not result in a partial disposition.
- Request verification of any disposition associated with a capitalized addition.
- Reconcile the partial dispositions to the tax return.
- Request a tour of the building(s).

DECISION POINT: If the taxpayer cannot substantiate a disposition occurred, you should disallow the partial disposition, adjust for the gain or loss recognized, and adjust the basis of the respective asset(s). See the Involuntary (Service-initiated) accounting method change procedures. These procedures are discussed in the Capitalization of Tangible Property Audit Technique Guide (ATG).

Step 2: Identify the Disposed Portion of the Building

Identify the disposed portion of the building.[5]

Considerations

Identifying the disposed portion of the building or its structural components is a facts- and circumstances determination for each disposition. Taxpayers must be able to substantiate the identity of the disposed portion of the building or its structural components.

Facts and Circumstances

You will generally not be able to identify the disposed portion relying solely on the taxpayer's tax depreciation schedules, or the description field on its fixed asset listings, as taxpayers were not required to keep records on portions of buildings or structural components of buildings prior to the disposition regulations.

The taxpayer cannot assume that every project capitalized as an improvement under IRC 263(a) resulted in a disposition of an existing portion of a building or structural component under Treas. Reg. 1.168(i)-8.

- An assumption that a partial disposition occurred in a building improvement project does not identify the portion of the building or its structural components disposed.
- Likewise, the capitalization of a new addition or structural component does not necessarily result in a partial disposition or identify the portion of the building or structural component disposed, if any.

The taxpayer may not own the disposed portion or structural component in a leased building, so they would not have a depreciable interest in it.

- Both the lessor and lessee of a leased building may have depreciable interests in portions of the building or its structural components.
  - For example, assume that a lessee leases a retail building and the lessor holds the depreciable interest in the building and its structural components.
    - Several years later, the HVAC system for the retail building needs to be replaced and the lessee pays for and capitalizes the replacement.
    - The lessee cannot take a partial disposition on the old HVAC system, as the lessee does not have a depreciable interest in the building or its structural components, including the HVAC.
    - Continuing with this example, if the lessee has to replace or restore a portion of the HVAC years later, then the lessee can claim a disposition on the portion of the HVAC system, provided the replacement/restoration is capitalized. The lessee has a depreciable interest in the replaced HVAC system it originally paid for and capitalized.

Books and Records

A taxpayer's books and records must be used to substantiate the identity of the portion of the building or the structural component disposed. 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.

Do the taxpayer's books and records (e.g. tax depreciation schedules) show buildings and building improvements and additions by location?

- Records showing the building and building improvements by location can assist in identifying what portion of a building or structural component was disposed.
  - Work orders, purchase orders, capital acquisition requests, and construction/demolition drawings may describe the replaced portion of a specific building or its structural components.
  - Reconcile the work orders, etc., to the tax depreciation schedules for dispositions and replacements.
- Example: Taxpayer owns several restaurant buildings. Taxpayer PIS a remodel on 7/1/2016 of Building A and labeled it “2016 Building A Remodel” on its tax depreciation schedules. Taxpayer can identify through its work orders, capital acquisition requests, and construction drawings for the removal (and replacement) of a portion of Building A’s HVAC system. The amounts reconcile from the work orders, capital acquisition requests and general ledger to Building A on the taxpayer’s tax depreciation schedules. The taxpayer has substantiated that there was a partial disposition of Building A, namely, its HVAC system, on 7/1/2016.

Review the dates of acquisition, remodel, demolition, and dispositions.

- Remodel projects may cross multiple years.
- Any structural components disposed in Year 1 of the remodel may only be elected in Year 1.

Determine whether taxpayer’s records can identify the portion of the building or structural components physically disposed of.

- Do the depreciation schedules, work orders, capital authorization requests, or construction/demolition drawings provide information on what portion was disposed of?

If the taxpayer identified a replaced component by reference to the replacement, then verify that the replacement components are the same type of components replaced, and the replacement and disposition are for the same building. For example:

- HVAC for HVAC on Building A
- Roof for roof on Building B
- Doors and windows for doors and windows on Building C

Verify the taxpayer has a depreciable interest in the building or structural component disposed.

There are no simplified methods provided in the regulations to identify the disposed portion of an asset, including a building or its structural components. Instead, the simplified methods in the regulations apply only to identify which asset was partially disposed of. See Step 3, Identifying Which Asset is Disposed of and Its Placed-in-Service Date, later in this Unit.

- Example: Taxpayer owns a retail building. Taxpayer's tax depreciation schedules show a fixed asset line item labeled "Store Remodel" on 7/1/2015, as a new capitalized improvement. Taxpayer states that the remodeling project involved the removal and replacement of all the doors and windows in the building. However, none of the documentation provided, such as work orders, etc., show that any doors or windows were removed.
  - The taxpayer cannot use any of the simplified methods provided in the regulations to assume that the 7/1/2015 store remodel resulted in any disposition of doors and windows, even if the retail building and its improvements can be identified in the tax depreciation schedules. The taxpayer must substantiate the identity of any portion of the building that was disposed of in the remodel project in its books and records.
  - Since the taxpayer cannot identify the doors and windows disposed of in their books and records, they have not substantiated that a partial disposition occurred and cannot recognize a partial disposition.

DECISION POINT: If the disposed portion cannot be identified from the taxpayer's books and records, then the taxpayer cannot recognize the partial disposition. You should disallow the partial disposition, adjust for the gain or loss recognized, and adjust the basis of the respective asset(s). See the Involuntary (Service-initiated) accounting method change procedures. These procedures are discussed in the Capitalization of Tangible Property ATG.

Step 3: Identify Partially Disposed Asset and PIS Date

Identify which asset is partially disposed of and its PIS date.[6]

Considerations

Identifying which asset is partially disposed of and its PIS date begins with the taxpayer's books and records. As with identifying the portion of a building or its structural components disposed of in Step 2, you may not be able to rely solely on the tax depreciation schedules, or the description field on the fixed asset listings, to identify which asset is partially disposed of.

Facts and circumstances for each disposition must be considered. A taxpayer's records are the starting point in determining whether a disposition occurred (Step 1), what portion of the asset was disposed of (Step 2), which asset was partially disposed of and its PIS date (Step 3), and the gain or loss recognized on the partial disposition of the asset (Step 4).

In General -Buildings

Usually, a taxpayer will account for a building, including its structural components, in a SAA, rather than in a MAA. See the Capitalization of Tangible Property ATG for further information on accounting for MACRS assets.

The general rules for determining the appropriate asset, including buildings and their structural components, for disposition purposes are outlined in the disposition regulations as follows.

Each building, including its structural components, is an asset. A building has the same meaning as that term is defined in Treas. Reg. 1.48-1(e)(1). A structural component has the same meaning as that term is defined in Treas. Reg. 1.48-1(e)(2).

- For example, a taxpayer acquired and PIS a building in Year 1 and put it in a SAA with a cost basis of $X. The building is an asset for disposition purposes.

If a building has two or more condominium or cooperative units, each condominium or cooperative unit, including its structural components, is the asset.

Each improvement or addition PIS after the building is a separate asset.

- For example, the taxpayer improved the building in Year 2 and put the improvement in a SAA with a cost basis of $Y. In Year 3, the taxpayer constructed an addition to the building and put the addition in a SAA with a cost basis of $Z. The improvement is an asset and the addition is an asset for disposition purposes. If the taxpayer disposed of a structural component, the taxpayer will need to determine which asset the disposed component is a part of the building, the improvement, or the addition.

A portion of an asset is any part of an asset that is less than the entire asset.

Methods Available to Determine the Asset Partially Disposed of and Its PIS Date

Remember, identification begins with the taxpayer's records.

Specific Identification Method

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.

- Example: In Year 1, the taxpayer acquires an existing building, PIS, and accounts for it in its books and records in a SAA. In Year 5, the taxpayer PIS an addition to the building and capitalizes the addition in a separate SAA. In Year 10, the taxpayer replaces a portion of the roof on the original building, and PIS and capitalizes the replacement roof in a separate SAA. The taxpayer can determine from its books and records that the partially-disposed asset is the original building PIS in Year 1.

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.

- Example SAA: A taxpayer has replaced various sections of a building's roof over multiple years. The taxpayer accounted for the original building, including its roof, in an SAA and has been capitalizing the partial roof replacements over the years as separate assets in their own SAA. When applying the disposition regulations after 2014, it is impracticable to specifically determine which assets contained the section of roof being disposed of. So, the taxpayer may use one of the simplified methods to identify the asset partially disposed of.

Allowable Other Simplified, Applicable Methods

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.

FIFO

The FIFO method may be used if the unadjusted basis of the partially-disposed asset CANNOT BE readily determined from the taxpayer's records.

- Under the FIFO method, the taxpayer identifies the asset (or account if a MAA situation) with the earliest PIS year that has the same recovery period as the partially-disposed asset and which is an asset (or account that has assets) at the beginning of the taxable year of disposition. The taxpayer treats the partially-disposed asset as being from that asset (or account).
- Example: Continuing with the earlier SAA example, if the taxpayer replaced a portion of the roof in 2018 and it cannot specifically identify which asset was partially disposed of, it can use the FIFO method to identify the original building as the partially-disposed asset.

Modified FIFO

The Modified FIFO method may be used if the unadjusted basis of the partially-disposed asset CAN BE readily determined from the taxpayer's records.

- Under the Modified FIFO method, the taxpayer identifies the asset (or account if a MAA situation) with the earliest PIS year that has the same recovery period as the partially-disposed asset and which is an asset (or account that has assets) at the beginning of the taxable year of the disposition.
- The taxpayer treats the partially-disposed asset as being from that asset (or account).

Mortality Dispersion Table

A Mortality Dispersion Table may be used, if the partially-disposed asset is a mass asset. Buildings and their structural components are rarely, if ever, part of a mass asset.

The Last-In-First-Out (LIFO) Method is specifically excluded as an applicable method allowed in identifying the asset or portion of an asset disposed of.

Pre-MACRS Assets

If the partially-disposed building or structural component is identified in the taxpayer's books and records as a pre-MACRS asset, the taxpayer cannot use any of the simplified methods to identify another MACRS building or structural component as being partially disposed of.

- Example: If the taxpayer disposes of a portion of a building and identifies the partially-disposed asset as the building PIS in 1985, they cannot ignore the pre-MACRS asset and use the FIFO method to identify another building asset in its books and records that was PIS after 1986 as being the partially-disposed asset.

Zero-Basis Assets

Similarly, if the partially-disposed building or structural component is identified as an asset with zero adjusted basis remaining at the time of disposition, the taxpayer cannot use a simplified method to identify another asset having adjusted basis remaining as the partially-disposed asset.

- Example: If the taxpayer disposes of a portion of a roof on a building, identifies the partially-disposed asset as the building and the building is fully depreciated at the beginning of the year of disposition, the taxpayer cannot ignore the zero-basis asset and use the FIFO method to identify another roof replacement, or any other asset on the building in its books and records that has basis remaining at the beginning of the year of disposition as being partially disposed of.

Assets of Same Type/Location

If a portion of an asset is replaced, the disposed portion must be of the same type and at the same location as the replacement asset, regardless of the method used to identify the partially-disposed asset.

- Example: If the taxpayer disposes of an HVAC system on a building and cannot identify the partially-disposed building in the same location, or if a taxpayer replaces an HVAC system on a building and can only identify a sprinkler system as the replaced asset, the taxpayer is not allowed a partial disposition because the assets are not of the same type or at the same location.

CAUTION: Reminder - FIFO is not allowed if the taxpayer's records allow the taxpayer to specifically identify the asset containing the disposed portion.

Taxpayer's Records – Facts-and-Circumstances Development

The taxpayer's records will have to substantiate the partially-disposed asset and its PIS date, just as the records substantiated that a disposition occurred (Step 1) and identified the disposed portion of the building or its structural component (Step 2). You will need to review the taxpayer's partial disposition computations and determine whether the particular year the partially-disposed asset can be identified in the taxpayer's records, or whether the taxpayer appropriately used one of the simplified methods to identify its PIS date. Consider the facts and circumstances for each partial disposition.

Replacement Asset and Disposed Structural Component

If a taxpayer replaced a portion of a building, or one of its structural components, and is claiming a partial disposition, the replacement asset must be capitalized. In addition, the disposed portion of the building or structural component identified by the taxpayer in its books and records must be of the same type, be in the same location (i.e., building), and have the same recovery period as the replacement asset.

Same Type and Same Location

Verify that the replacement asset and the replaced asset are the same. The disposed portion of the building or structural component identified in the taxpayer's books and records and the improvement must be of the same type and at the same location.

- Example: Taxpayer replaces the HVAC system in the current year at one of its building locations and identifies the replaced asset as a 20-year-old HVAC system at another location. These assets are of the same type but are not in the same location.
- Example: Taxpayer installs a new humidifier asset at one of its building locations and identifies the disposed asset as a 10-year-old water pump at the same location. These assets are at the same location but are not the same type.

Same Recovery Period

Verify that the replacement asset and the replaced asset have the same recovery period. The disposed portion of the building or structural component identified in the taxpayer's books and records and the improvement must be of the same recovery period.

- Example: Taxpayer installs a new water system asset in one of its buildings. The new water system asset has a recovery period of 15 years. Taxpayer identifies a 39-year-life water system asset in the same building as the disposed structural component. These assets do not have the same recovery period.

Pre-MACRS Property

Determine that the partially-disposed asset is MACRS property. Only MACRS property is eligible for a partial disposition election, (i.e. pre-MACRS property is not eligible).

- Example 1: In 2015, taxpayer disposed of the roof on one of its buildings and capitalized the replacement. Taxpayer can identify in its books and records that the disposed roof was a portion of the building that was PIS in July 2000. Taxpayer can make a partial disposition election for 2015 and claim a loss on the disposed roof.

- Example 2: Same as Example 1, except assume that the disposed roof was a portion of a building that was PIS prior to 1987 and is not MACRS property. Taxpayer cannot use any of the simplified methods, such as FIFO, to identify another MACRS asset in its books and records as the partially-disposed asset. Taxpayer would not be allowed to recognize a partial disposition on the disposed roof.

Zero-Basis Asset

Determine that the asset with the partial disposition has an adjusted basis greater than $0. If the asset does not have any basis remaining, a loss cannot be calculated on a partial disposition of the asset.

- Example: Taxpayer replaces the entire plumbing system in one of its buildings in 2018. Taxpayer can identify in its books and records that the disposed plumbing system was a portion of the building that was PIS in 1988 with a 27.5-year life. Since the building has been fully depreciated and does not have an adjusted basis greater than $0, it is a zero-basis asset and the taxpayer cannot claim a loss on the partial disposition.
  - Taxpayer cannot use one of the simplified methods, such as FIFO, to identify another MACRS asset that has adjusted basis remaining as the partially-disposed asset.

Comprehensive - Methods Used to Identify the Asset Partially Disposed of and Its PIS Date

A taxpayer's books and records are used to identify the asset partially disposed of and its PIS date. Taxpayers must use the specific identification method to identify the asset partially disposed of and its PIS date or, if it is impracticable from the taxpayer's records to identify the PIS date of the partially-disposed asset, use one of the applicable methods (FIFO or Modified FIFO).

Specific Identification Method

Determine which specific asset included the disposed portion of the building or its structural component identified in Step 2.

- Example: Taxpayer can identify from its books and records that HVAC units B, C and D in one of its buildings were disposed of in its 2015 office remodel. Taxpayer can identify in its records that these units were part of Asset #1234, HVAC Upgrade, PIS in 2004 at the same building location.

FIFO or Modified FIFO Method

If specific identification is not practicable from taxpayer's records, a taxpayer may use the FIFO or Modified FIFO method to identify the partially-disposed asset's PIS date.

- Example 1: Taxpayer owns a building that was PIS in 1990. Taxpayer replaces and capitalizes 60% of the roof. Ten years later, taxpayer replaces 55% of the roof on the same building.

- Taxpayer cannot specifically identify if the disposed 55% of the roof is some, part, or all of (a) the remaining 40% of the original roof (building asset) or (b) the 60% of the roof replacement (improvement asset).
- Using the FIFO method, the taxpayer disposed of the remaining 40% of original roof first and then 15% of the 60% roof replacement.

■ Example 2: Same facts as Example 1 from the previous page, but the PIS date of the building was 7/1/1985. The building is pre-MACRS property.

- Using the FIFO method, as in Example 1, the taxpayer disposed of the remaining 40% of the original roof first and then 15% of the 60% roof replacement.
  - Taxpayer cannot recognize a partial disposition on the 40% of the original roof.
  - Taxpayer can only recognize a partial disposition on the 15% of the 60% roof replacement. When applying the FIFO or Modified FIFO method to identify the asset partially disposed of and its PIS date, if pre-MACRS property is identified, it cannot be ignored.

■ Example 3: The taxpayer has truncated its pre-MACRS (pre-1987) assets from its fixed asset listings. Same facts as in Example 2 above.

- Taxpayer cannot use the FIFO or Modified FIFO method to identify the disposed 55% portion of the roof as entirely from the 60% roof replacement.

The simplified applicable methods are available for a taxpayer's use when it is impracticable from the taxpayer's books and records to identify the asset partially disposed of and its PIS date. There are no simplified methods to determine if a disposition occurred (Step 1) or to identify the portion of the building or a structural component disposed of (Step 2).

DECISION POINT: If the taxpayer has properly identified the asset partially disposed of and its PIS, consider whether to continue examining for the correct gain or loss computation and adjusted basis of the remaining portion of the asset.

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.

DECISION POINT: If one of these situations applies, you should disallow the partial disposition, adjust for the gain or loss recognized, and adjust the basis of the respective asset(s). See the Involuntary (Service-initiated) accounting method change procedures. These procedures are discussed in the Capitalization of Tangible Property ATG.

Step 4: Determine Disposed Portion's Adjusted Basis

Determine the adjusted basis of the disposed portion of the asset.[7]

Considerations

The starting point to determine the adjusted basis of the disposed portion of an asset is the unadjusted basis of the entire asset. The unadjusted basis is generally its cost, but exceptions or special rules may apply. For example, the unadjusted basis of an asset is reduced by any portion of the basis the taxpayer properly elects to treat as an expense under IRC 179.[8]

The regulations allow a taxpayer to use reasonable methods to calculate the UNADJUSTED basis if:

- The asset is contained in a MAA, or
- The disposition is of a portion of an asset, AND
- It is impracticable from the taxpayer's records to determine the unadjusted depreciable basis of the disposed asset or portion of an asset.[9]

The term impracticable is not defined in the regulations, but impracticable should be interpreted in light of the record-keeping requirements discussed previously and provided in the disposition regulations. The taxpayer must first look to existing books and records and supplement those records with the reasonable methods.

Reasonable Methods

Reasonable methods to determine the unadjusted basis for a portion of an asset include, but are not limited to:

- Discounting the cost of the replacement portion of the asset to its PIS year cost using the Producer Price Index (PPI) for Finished Goods, the PPI for Final Demand, or other index designated by guidance in the Internal Revenue Bulletin.
  - This method can only be used if the replacement portion is a restoration defined in Treas. Reg. 1.263(a)-3(k).
    - It cannot be used if the replacement portion is a betterment as defined in Treas. Reg. 1.263(a)-3(j) or an adaption as defined in Treas. Reg. 1.263(a)-3(l).
  - There may be instances when discounting the cost of the replacement value is not a reasonable method to be used.
    - Example 1: Taxpayer purchases a building at a reduced value because the building needs refurbishment. Taxpayer places the building in service and

later replaces the roof. The cost to replace the roof exceeds the original cost basis of the building.

- Example 2: Taxpayer purchases a building on 1/1/2016, that has been in service for 15 years and has a roof that is original to the building. Ten years later, 1/1/2026, the taxpayer replaces the entire roof and identifies the building as the partially-disposed asset. Discounting the cost of the replacement roof to the building's PIS date (1/1/2016) overstates the unadjusted basis of the replaced roof because it was not new when the building was PIS. The taxpayer should reduce the discounted amount to take into account the age and condition of the roof when the building was PIS (1/1/2016).

- Pro rata allocation of the unadjusted depreciable basis of the asset based on the replacement cost of the disposed portion of the asset and the replacement cost of the asset.

- Study allocating the cost of the asset to its individual components.[10]

Unadjusted Basis

The unadjusted basis of the entire asset is known before dividing that unadjusted basis into parts for the disposition of a portion of an asset (i.e., building or its structural components).

It is important to note that the unadjusted basis of a portion of an asset may not exceed the unadjusted basis remaining in the entire asset. See Example 1 on page 20.

It is also important to remember that the taxpayer must determine if there is any adjusted basis remaining in the partially-disposed asset at the time of the partial disposition, regardless of whether they can determine the unadjusted basis of the disposed portion. If there is no adjusted basis remaining, (i.e., the asset is fully depreciated, no partial disposition is allowed). As discussed above in Step 3, the taxpayer cannot identify another asset in its books and records with remaining adjusted basis as the asset that is partially disposed of.

Once a taxpayer uses a reasonable method to determine the unadjusted basis of the first disposed portion of an asset, the reasonable method must be consistently applied to all portions of the same asset for purposes of determining the unadjusted basis of a disposed portion of the asset.[11]

Adjusted Basis

Once the unadjusted basis of the disposed portion of the asset is determined, then the adjusted basis of the disposed portion can be computed. The adjusted basis is calculated by decreasing the unadjusted basis by the greater of the depreciation allowed or allowable[12]. The result is the asset's adjusted depreciable basis. This is the term used in the regulations, but for purposes of this Practice Unit, we also use the term adjusted basis.

To determine the adjusted basis of the disposed portion of the asset, the depreciation allowed or allowable for the disposed portion is computed using the:

- Depreciation method,
- Recovery period, and
- Convention applicable to the asset in which the disposed portion is included, and
- Including the portion of any additional first-year depreciation deduction that is attributable to the disposed portion.[13]

General Rules -Recognition of Gain or Loss

The adjusted basis of an asset disposed of, for computing gain/loss, is its adjusted depreciable basis at the time of the asset's disposition. [14]

The recognition of gain or loss upon the disposition of property applies to:

1. The disposition of an entire asset,
2. The partial dispositions of an asset that the taxpayer elects to recognize, and
3. The mandatory (required) partial dispositions of an asset.

The following rules apply:

- If an asset or portion of an asset is disposed of by sale, exchange, or involuntary conversion, gain or loss is recognized under the applicable Code provisions.[15]
- If an asset or portion of an asset is disposed of by physical abandonment, loss is recognized in an amount equal to the adjusted depreciable basis at the time of abandonment.
  - The taxpayer must intend to discard the asset or portion of the asset irrevocably so that they will not use it again or retrieve it for sale, exchange or other disposition in order to recognize a loss from physical abandonment. However, if the abandoned asset is subject to nonrecourse indebtedness, gain or loss is recognized under the applicable Code provisions.[16]
- If a taxpayer disposes of an asset or portion of an asset other than by sale, exchange, involuntary conversion, physical abandonment, or conversion to personal use, loss is recognized equal to the excess of the adjusted depreciable basis of the asset over the asset's fair market value (FMV) at the time of the disposition. A gain is not recognized.[17]

Recap and Example

Before the basis of the portion of the asset disposed of can be determined, the first three steps outlined in this Practice Unit and contained in the regulations are applied:

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- Step 1 – Based on the taxpayer's existing records, determine that a partial disposition occurred.
- Step 2 – Based on the taxpayer's existing records, identify the disposed portion of the asset.
- Step 3 – Based on the taxpayer's records or, if impracticable, using one of the simplified methods (e.g., FIFO), identify which asset is partially disposed of and its PIS date.

After the first three steps are used, then the unadjusted basis and adjusted depreciable basis of the asset and portion disposed of is determined (Step 4).

Step 4 and the regulations provide that when disposing of a portion of an asset and it is impracticable from the taxpayer's records to determine the unadjusted depreciable basis of the disposed portion of an asset, a taxpayer may use any reasonable method in determining the unadjusted basis.

- Cost of replacement using PPI or another applicable index.
- Pro rata allocation of the unadjusted depreciable basis of the asset based on the replacement cost of the disposed portion of the asset and the replacement cost of the asset.
- Study allocating the cost of the asset to its individual components.

Example:

- On 7/1/2011, taxpayer places a building in service and accounts for the building as a single asset in a SAA with a cost of $20,000,000. On 6/30/2014, taxpayer replaces one of two elevators and capitalizes the replacement. The taxpayer did not sell the elevator but disposed of the elevator through an abandonment (IRC 165) loss. Taxpayer makes a partial disposition election. It is impracticable from the taxpayer's records to determine the adjusted basis of the elevator disposed of.
- Determine Adjusted Depreciable Basis
  - Taxpayer determines the basis by discounting the replacement cost of the elevator to its PIS cost using PPI for Final Demand.
    - Using this method taxpayer determines $150,000 of the $20,000,000 unadjusted basis of the building relates to the disposed elevator.
  - Adjusted Depreciable Basis is $138,780
    - Depreciation allowed or allowable
      - Using the same recovery period, method and convention as the building, it is determined that the depreciation allowed on the elevator disposed of is $11,220.

- $150,000 unadjusted basis less $11,220 depreciation allowance equals an adjusted depreciable basis of $138,780.

– The $138,780 is a loss sustained on the disposition of the elevator, a structural component of the building.

Remember that additions or improvements to a building that are PIS after the original building are separate assets and are generally accounted for in SAAs, not MAAs. So, there will be a number of assets relating to one building. For purposes of identifying the partially-disposed asset (Step 3) and the unadjusted basis of the portion of the asset disposed of, the building and its subsequent additions and improvements are not treated as a single MAA but as a series of SAAs.

DECISION POINT: If the taxpayer has properly determined the adjusted depreciable basis of the portion of the asset disposed of, continue examining the partial disposition for the accounting of the disposed portion of the asset on the taxpayer's books and records (Step 5).

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,

then you should disallow the partial disposition, adjust the gain or loss recognized, and adjust the basis of the respective disposed asset(s). See the Involuntary (Service-initiated) accounting method change procedures. These procedures are discussed in the Capitalization of Tangible Property ATG.

Step 5: Reduce Adjusted Basis of the Asset

Account for the disposed portion; reduce the adjusted basis of the asset by the disposed portion.[18]

Considerations

Buildings and their structural components are generally held in SAAs. When an asset is disposed of, depreciation ends at the time of the asset's disposition. If an asset is held in a SAA, the SAA terminates at the time of the asset's disposition.

Assets are accounted for on an asset-by-asset basis. The unadjusted basis and accumulated depreciation of a disposed asset or the portion of the asset disposed of, must be accounted for and removed on an asset-by-asset basis.

When a partial disposition of an asset (i.e., a building or its structural components) occurs, depreciation for the disposed portion ends at the time of the disposition. The basis and depreciation reserve of the partially-disposed asset, as of the first day of the tax year, is taken into account before the depreciation deduction is calculated for the year of disposition.

The following is how a partial disposition is accounted for in a taxpayer's books and records and for tax purposes:

- On the first day of the taxable year of disposition:
  - The unadjusted depreciable basis of the disposed portion of the asset is moved into a SAA.
  - The unadjusted depreciable basis of the asset is reduced by the unadjusted depreciable basis of the disposed portion.
  - There are now two asset accounts on the books and records – one for the disposed portion and one for the remaining asset.

Adjusted Basis – Remaining 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.

- Reduce the depreciation reserve of the asset as of the end of the tax year preceding the year of disposition by the depreciation accumulated on the disposed portion (using the depreciation method, recovery period and convention of asset).

Adjusted Basis -Disposed Portion

The amount of allowable depreciation associated with the disposed portion of the asset is calculated on the disposed portion only. The disposed portion is placed into a SAA as of the beginning of the year of disposition.

- Increase the depreciation reserve for the depreciation allowed on the disposed portion of the asset at the end of the tax year preceding the year of the disposition. This is the calculation from the prior step.

Adjusted Basis at Time of Disposition

Determine the adjusted depreciable basis of the disposed portion of the asset at the time of disposition.

- Use the depreciation method, recovery period, and convention applicable to the asset that was partially disposed of.
  - Continue depreciating the remaining portion of the asset not disposed of, using the same depreciation method, recovery period and convention as was used when the asset was first PIS.

DECISION POINT: If the taxpayer has properly accounted for the disposition and the gain or loss recognized is accurate, there are no adjustments to be made. If the taxpayer has not accounted for the partial disposition accurately on its books and records, adjust the basis of the respective assets, and adjust the depreciation expense, if needed. See the Involuntary (Service-initiated) accounting method change procedures. These procedures are discussed in the Capitalization of Tangible Property ATG.

Glossary of Terms and Acronyms

Term/Acronym	Definition
Asset	For disposition positions, Each building (including its structural components) is the asset. If the building includes two or more condominium or cooperative units, each condominium or cooperative unit (including its structural components) is a separate asset. After a taxpayer places a building in service, each improvement or addition to that building is a separate asset.
ATG	Audit Technique Guide
Building	For purposes of the Disposition Regulations, has the same meaning as that term is defined in Treas. Reg. 1.48-1(e)(1). The term "building" generally means any structure or edifice enclosing a space within its walls, and usually covered by a roof, the purpose of which is, for example, to provide shelter or house, or to provide working, office, parking, display, or sales space. The term includes, for example, structures such as apartment houses, factory and office buildings, warehouses, barns, garages, railway or bus stations, and stores. Such term includes any such structure constructed by, or for, a lessee even if such structure must be removed, or ownership of such structure reverts to the lessor, at the termination of the lease.
CAM	Change in Method of Accounting
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.[19] A disposition includes the sale, exchange, retirement, physical abandonment, or destruction of an asset. A disposition also occurs when an asset is transferred to a supplies, scrap, or similar account, or when a portion of an asset is disposed of. A

Term/Acronym	Definition
	disposition also includes the disposition of a building's structural component or such portion thereof.
Disposition Regulations	Treas. Reg. 1.168(i)-8. Published in T.D. 9689; 2014-36 I.R.B. 456, September 2, 2014.
FIFO	First-In-First-Out
HVAC	Heating, Ventilation, and Air-conditioning
LIFO	Last-In-First-Out
MAA	Multiple Asset Account
MACRS Property	Modified Accelerated Cost Recovery System (MACRS) property is defined in Treas. Reg. 1.168(b)-1(a)(2) as tangible, depreciable property that generally is placed in service after 12/31/1986, and subject to IRC 168.
PPI	Producer Price Index
PIS	Placed in Service
SAA	Single Asset Account
Structural Components	For purposes of Disposition Regulations, has the same meaning as that term is defined in Treas. Reg. 1.48-1(e)(2). ■ The term "structural components" includes such parts of a building as walls, partitions, floors, and ceilings, as well as any permanent coverings such as paneling or tiling; windows and doors; all components (whether in, on, or adjacent to the building) of a central air conditioning or heating system, including motors, compressors, pipes and ducts; plumbing and plumbing fixtures, such as sinks and bathtubs; electric wiring and lighting fixtures; chimneys; stairs, escalators, and elevators, including all components thereof; sprinkler systems; fire escapes; and other components relating to the operation or maintenance of a building. ■ However, the term "structural components" does not include machinery the sole justification for the

Term/Acronym	Definition
	installation of which is the fact that such machinery is required to meet temperature or humidity requirements which are essential for the operation of other machinery or the processing of materials or foodstuffs. Machinery may meet the “sole justification” test provided by the preceding sentence even though it incidentally provides for the comfort of the employees, or serves, to an insubstantial degree, areas where such temperature or humidity requirements are not essential. For example, an air conditioning and humidification system installed in a textile plant in order to maintain the temperature or humidity within a narrow optimum range which is critical in processing particular types of yarn or cloth is not included within the term “structural components.”
TPR	Tangible Property Regulations
UOP	Unit of Property

Related Practice Units

- Identifying a Taxpayer Electing a Partial Disposition

Training and Additional Resources

Training PowerPoint

- MACRS Property Disposition Reg Part 1 -2015 Centra
- MACRS Property Disposition Reg Part 2 -2015 Centra
- Tangible Regulations Part 1 - 2014 Centra
- Tangible Regulations Part 2 - 2014 Centra

Additional Resources

- Audit Technique Guide, Capitalization of Tangible Property
- MACRS Dispositions FAQs

- Electing a Partial or a Late Partial Disposition Job Aid
- MACRS Property Overview Job Aid
- MACRS Property Record Keeping Requirements Job Aid
- What is a MACRS Disposition? Job Aid

References

[1] TD 9689 -Guidance Regarding Dispositions of Tangible Depreciable Property

[2] Treas. Regs. 1.167(a)-7(c), 1.167(i)-7, 1.168(i)-8, and 1.263(a)

[3] Capitalization of Tangible Property Audit Tecnique Guide

[4] Form 3115, Application for Change in Accounting Method

[5] IRCs 167 and 168

[6] Treas. Regs. 1.167(a)-7(c), 1.168(i)-7, 1.168(i)-8, 1.263(a), and Capitalization of Tangible Property Audit Technique Guide

[7] IRC 179, Treas. Regs. 1.168(b)-1(a)(3), 1.168(i)-8, 1.168(i)-8(f)(2), 1.168(i)-8(f)(3) and 1.167(a)-7(c).

[8] Treas. Reg. 1.168(b)-1(a)(3)

[9] Treas. Reg. 1.168(i)-8(f)(2) and (3)

[10] Treas. Reg. 1.168(i)8(f)(3)

[11] Treas. Reg. 1.168(i)-8(f)(3)(i)

[12] IRC 1016(a)(2)

[13] Treas. Reg. 1.168(i)-8(f)(3)(ii)

[14] Treas. Reg. 1.168(i)-(8)(f)(1)

[15] Treas. Reg. 1.168(i)-8(e)(1)

[16] Treas. Reg. 1.168(i)-8(e)(2)

[17] Treas. Reg. 1.168(i)-8(e)(3)

[18] Treas. Regs. 1.167(a)-7(c), 1.168(i)-7 and 1.168(i)-8

[19] Treas. Reg. 1.168(i)-8(b)(2)