Final Repair Regulations — Introduction to the Unit of Property

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2014-Issue 16—In a recent edition of *A&M Tax Advisor Weekly*, "A Capital Idea — Present and Future Ramifications of the IRS's Final Repair Regulations," we provided an overview of the final repair regulations. Given the extensive nature of the regulations and the effective date of tax years beginning January 1, 2014, companies that own or lease any tangible property will be impacted to at least some degree. While there are numerous topics that can be addressed given the complexity and length of the repair regulations (over 200 pages), this article focuses on one aspect that we expect will create particular implementation complexities: the unit of property (UOP).

Unit of Property

The regulations generally define a unit of property as consisting of all components of property that are functionally interdependent, and provide special rules for determining the unit of property for buildings, plant property and network assets. While a building is defined as a unit of property, the regulations require the application of the improvement standards to the building structure and eight building systems. Furthermore, the regulations provide special rules for determining the units of property for condominiums, cooperatives and leased property, and for the treatment of improvements (including leasehold improvements). Property that is aggregated or subject to a general asset account election or accounted for in a multiple asset account may not be treated as a single unit of property.

Buildings and Building Systems

As outlined in the repair regulations, in the case of buildings, each building and its structural components is a single, separable unit of property. Corresponding costs must be allocated between the building structure and its components that constitute a separate building system. To the extent the particular facts and circumstances of a subset of buildings used in one or more industries present unique challenges to the application of the building structure or building system definitions, taxpayers are encouraged to request guidance under the Industry Issue Resolution procedures. If such additional guidance is not available, a facts and circumstances analysis must be performed that is consistent with the concept of functionally interdependent assets (e.g., certain oil and gas assets such as a well, etc.)

The repair regulations define the eight building systems as follows:

1. Heating, ventilation and air conditioning (HVAC) systems (including motors, compressors, boilers, furnace, chillers, pipes, ducts, radiators);
2. Plumbing systems (including pipes, drains, valves, sinks, bathtubs, toilets, water and sanitary sewer collection equipment, and site utility equipment used to distribute water and waste to and from the property line and between buildings and other permanent structures);

3. Electrical systems (including wiring, outlets, junction boxes, lighting fixtures and associated connectors, and site utility equipment used to distribute electricity from the property line to and between buildings and other permanent structures);
4. All escalators;
5. All elevators;
6. Fire-protection and alarm systems (including sensing devices, computer controls, sprinkler heads, sprinkler mains, associated piping or plumbing, pumps, visual and audible alarms, alarm control panels, heat and smoke detection devices, fire escapes, fire doors, emergency exit lighting and signage, and fire-fighting equipment, such as extinguishers, and hoses);
7. Security systems for the protection of the building and its occupants (including window and door locks, security cameras, recorders, monitors, motion detectors, security lighting, alarm systems, entry and access systems, related junction boxes, associated wiring and conduit); and
8. Gas distribution system (including associated pipes and equipment used to distribute gas to and from the property line and between buildings or permanent structures).

Key Compliance Considerations

While new improvements will be assigned as incurred to each applicable unit of property, there is a more immediate action required to conform existing properties to the unit of property rules. The unit of property is a key factor in a number of actions (i.e., whether or not to capitalize or deduct future expenditures, write-offs associated with disposed assets, etc.). As most companies historically have treated a building and all components as one UOP, the new requirement to separate the building into a building structure and eight building systems is a significant change, and one in which companies are just beginning to realize that the implementation of the unit of property rules could be a complex and time-consuming process (although many companies that have conducted cost segregation analyses will have a head start, as discussed below). The process can be difficult for one building, not to mention the necessity of incorporating this change for all properties.

What is the most efficient approach to the initial allocation between building structure and building systems? The first question to ask is whether or not a cost segregation analysis has been previously performed on the building. If so, the results of the cost segregation may provide a road map for the allocation, given that it would have separated certain assets into Modified Accelerated Cost Recovery System (MACRS) categories that will have some comparability to the unit of property. However, even though some assets may have been moved to shorter-life MACRS categories as part of a cost segregation analysis, certain assets remaining in the 39-year category would still need to be considered for further unit of property analyses and separation (i.e., elevators and escalators). Therefore, it is important to note that a previously executed cost segregation analysis will be very helpful but likely will not provide a complete bridge to allocating value to units of property, thus requiring further analysis.

If a cost segregation analysis has not been conducted, the next step is to select a sample of buildings and conduct an analysis using valuation and engineering techniques to separate assets between the building structure and the eight aforementioned building systems. Starting with a few properties as a representative sample, one can assess the availability and usability of data inputs necessary to complete the study for this sample, and then develop efficient processes for all other properties. These data inputs would include the fixed-asset records (preferably tax ledgers), engineering drawings and blueprints, invoices and other data that will play a key role in the analysis. Note that application of the improvement rules does not trigger a change in the MACRS lives of the assets. Thus, the potential financial benefits of a cost segregation analysis should be considered, given that the often overlapping tasks of conducting both analyses simultaneously could prove to be economically beneficial.

Property Other Than Buildings

In addition to buildings, other assets are subject to the improvement rules, namely:

- Plant property; and
- Network assets.

Plant property is defined as functionally interdependent machinery or equipment (other than network assets) that is used to perform an industrial process (e.g., manufacturing, generation, warehousing, distribution, automated materials handling in service industries, or other similar activities). Components of property are considered functionally interdependent if the placing in service of one component is dependent on the placing in service of the other component. The UOP for plant property is further divided into smaller units made up of each component that performs a discrete and major function or operation within the functionally interdependent machinery or equipment.

Network assets can be further described as railroad track, oil and gas pipelines, water and sewerage pipelines, power transmission and distribution lines, and telephone and cable lines that are owned or leased in each of those respective industries. For network assets, the unit of property is determined by the particular facts and circumstances except as otherwise provided in published guidance in the Federal Register or in the Internal Revenue Bulletin.

Key Compliance Considerations

The allocation to unit of property for plant property carries its own complexities given the need to review for functional interdependence, components that perform a discrete and major function, and other facts and circumstances that may be applicable to determining whether property placed in service is a major component or a substantial structural part.

Similar to the approach for separating building systems from the building structure, for the plant property one should begin with a sample of properties and/or material asset systems for identifying and allocating value to units of property. The key components to perform the analysis will include detailed fixed-asset records (preferably tax ledgers) containing asset class, year placed in service, MACRS life, historical cost and net book value for each asset. Access to maintenance records, calibration lists and componentization studies can also provide useful insight, and a plant tour including discussions with a plant manager and/or engineering/maintenance manager would be ideal. This analysis is complemented by applying valuation techniques (cost and/or market approaches) to estimate a value for each asset, which can entail estimating value based on the depreciated replacement cost of each asset, as well as observed secondary market prices. Using these valuation techniques, the resulting estimate of value of each asset can then be applied in allocating the costs of assets to each unit of property.

Focusing on the plant property category, we highlight an example provided in the regulations. A company operates a uniform and linen rental business, and owns and operates a plant that uses many different machines in an assembly-line-like process to treat, launder and prepare rental items for its customers. There are two laundering lines in its plant, each of which can operate independently. One line is used for uniforms and another line is used for linens, and both lines incorporate a sorter, boiler, washer, dryer, ironer, folder and wastewater treatment system. The equipment is all considered to be property other than a building, thus the unit of property for the laundering equipment comprises all the components that are functionally interdependent. Under this rule, the initial units of property are each laundering line because each line is functionally independent and comprises components that are functionally interdependent. However, because each line is made up of plant property, these initial units of property must be further divided into smaller units of property by determining the components (or groups of components) that perform discrete and major functions within the line. Thus, each sorter, boiler, washer, dryer, ironer, folder and wastewater treatment system in each line must be treated as a separate unit of property because each of these components performs a discrete and major function within the line.

Leased Properties

In situations where all or a portion of a building (e.g., an office, floor or certain square footage) is leased, the unit of property for the lessee includes the following:

- Entire building — if the entire building is leased by the lessee, the building structure or any building system that is part of the leased building.
- Portion of a building — when the lessee is leasing a portion of a building (e.g., office, floor or certain square footage), the portion of the building structure subject to the lease or the portion of any building system that is subject to the lease.

The regulations specify that for purposes of determining whether an amount paid by a lessee constitutes a leasehold improvement, the unit of property and the improvement rules are applied in accordance with the rules for leased buildings (or leased portions of a building) or for leased property other than buildings. Thus, for example, if a lessee pays an amount for work on an addition that it previously made to a leased building, the taxpayer would determine whether the work performed constitutes an improvement to the entire leased building structure, not merely to the addition. The regulations also clarify that when a lessee or lessor improvement involves a building erected on leased property, then the unit of property for the building and the application of the improvement rules are determined under the provisions for buildings, rather than under the provisions for leased buildings.

Depreciation Consistency Rule

As mentioned previously, applying the improvement rules to existing assets does not create a change in the MACRS lives of the affected assets. However, the opposite is true for any change in depreciable lives. If at any point subsequent to the taxable year after the unit of property is initially placed in service, any change is made to the MACRS class or to the depreciation method (for example a cost segregation study is conducted), the taxpayer must change the unit of property determination to be consistent with the change in treatment for depreciation purposes. Thus, for example, if a portion of a unit of property is properly reclassified to a MACRS class different from its previous MACRS class, the reclassified portion of the property should be treated as a separate unit of property.

Accounting Method Changes

On January 24, 2014, the IRS released Rev. Proc. 2014-16, which modifies certain procedures previously issued under the temporary regulations regarding changes in the method of accounting for amounts paid to acquire, produce or improve tangible property. Rev. Proc. 2014-16 is designed to help taxpayers further analyze their current methods of accounting and implement any necessary changes. An upcoming edition of *Tax Advisor Weekly* will be dedicated to describing the accounting method changes pursuant to Rev. Proc. 2014-16 and offer insight into the timing for implementation of any changes.

Alvarez & Marsal Taxand Says:

The repair regulations introduce a broad array of issues that need to be addressed. Among them, the unit of property could be one of the more complex and time-consuming areas, given the effort required to conform current reporting practices with the requirements of the repair regulations. Given the effect of the unit of property on the treatment of future expenditures, asset dispositions, etc., it is vital for companies to very quickly develop a strategy for how to most efficiently and effectively implement the allocation of assets to units of property. Furthermore, the recently issued Rev. Proc. 2014-16 should be addressed to analyze if more immediate action should be taken regarding the units of property (and other repair regulation requirements) relative to method of accounting changes.

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