

Office of Chief Counsel  
Internal Revenue Service  
**Memorandum**

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to:  
Account Coordinator ( )  
(Large Business & International)

from:  
Associate Area Counsel ( )  
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subject: I.R.C. § 168 - Loss on Disposition of Building Structural Components<sup>1</sup>  
("Taxpayer")  
Tax Year

**DISCLOSURE STATEMENT**

This memorandum responds to your request for assistance. This advice may not be used or cited as precedent. This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

**ISSUE**

For tax year , Taxpayer sought to change its accounting method to recognize gain or loss on disposition of building structural components in the year of disposition, in accordance with Prop. Treas. Reg. § 1.168(i)-(8), 2013-43 I.R.B. 404. Taxpayer statistical sampling study , which concluded that Taxpayer is entitled to a structural component disposition loss ("SCD loss") of for tax

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<sup>1</sup> Subsequent section references are to the Internal Revenue Code of 1986, as amended and in effect during the tax years at issue and to the Treasury regulations promulgated thereunder.

year . At issue is whether Taxpayer is entitled to the loss, which turns on whether the study met the requirements of proposed section 1.168(i)-(8).

### CONCLUSION

Taxpayer is not entitled to the full amount of the SCD loss estimated in its statistical sampling study. incorrectly applied the proposed section 168 regulations by identifying SCD losses when Taxpayer installed new assets without establishing that Taxpayer: (1) had actually disposed of assets when it installed a new asset; or (2) had adjusted depreciable basis in a building, leasehold improvement, or single asset account at the time of the disposition that would give rise to a SCD loss.

also used an incorrect method to calculate the SCD loss when it compared the cost basis of new assets with Taxpayer's oldest assets because the assets were not of the same type and may not have been disposed of. Additionally, relied on Taxpayer records that did not fully substantiate the estimated SCD loss.

### FACTS

At all relevant times, Taxpayer was . It operated locations with of owned and leased facilities,

Through its tax year ended , Taxpayer capitalized and depreciated building structural components as fixed assets under section 168(a). Taxpayer did not recognize a loss when it disposed of building structural components but instead continued to depreciate them.

For its tax year ended , Taxpayer filed a Form 3115 (Change in Accounting Method) to adopt the method of accounting for dispositions of building structural components prescribed by temporary section 168 regulations. Treas. Reg. § 1.168(i)-8T. Taxpayer a statistical sampling study to identify assets (or portions of assets) that Taxpayer had disposed of but was still depreciating. █  
█  
█

For its tax year ended , Taxpayer filed another Form 3115 to adopt the method of accounting for dispositions of building structural components to the method prescribed by the 2013 proposed section 168 regulations. Prop. Treas. Reg. §

1.168(i)-8. Taxpayer \_\_\_\_\_ a statistical sampling study \_\_\_\_\_ to identify assets (or portions of assets) that Taxpayer had disposed of but was still depreciating. \_\_\_\_\_ determined that \_\_\_\_\_ of the \_\_\_\_\_ sampled records contained a disposition for which Taxpayer could claim a SCD loss. Extrapolating that result, proposed a \_\_\_\_\_ section 481(a) adjustment for Taxpayer's \_\_\_\_\_ year.

Taxpayer provided \_\_\_\_\_ study to you in May \_\_\_\_\_ and adopted \_\_\_\_\_ results when it filed its \_\_\_\_\_ federal income tax return on \_\_\_\_\_.

In preparing its statistical sampling study, \_\_\_\_\_ relied on Taxpayer's schedule of all buildings it owned or leased at each of its locations. \_\_\_\_\_ also relied on Taxpayer's fixed asset databases, which include building and personal property assets at Taxpayer's locations ("cost histories"). The cost histories included asset location, description, tax life, depreciable cost basis, bonus depreciation elections, accumulated depreciation, placed in service ("PIS") date, and net tax value. Taxpayer did not use multiple asset accounts. The accuracy and detail of the cost histories varied because \_\_\_\_\_.

\_\_\_\_\_ goal was to estimate the adjusted basis of the total population of \_\_\_\_\_ building structural components based on extrapolation of the results of its review of sampled records. In identifying a sample pool of \_\_\_\_\_, \_\_\_\_\_ excluded assets with less than a 15-year recovery period, assets in non-building-related asset categories (e.g., computer software and vehicles), and assets with personal property asset descriptions.

\_\_\_\_\_ referenced the building structural components in the sample by \_\_\_\_\_

Each \_\_\_\_\_ identified the location of a capital improvement project and provided a brief description of the work done. Some \_\_\_\_\_ described a number of individual assets recorded in Taxpayer's cost histories. Some buildings and locations were identified in multiple \_\_\_\_\_. Some \_\_\_\_\_ described work at locations for which Taxpayer's cost histories did not include a building. Taxpayer provided additional supporting documentation for some \_\_\_\_\_, but the cost histories were the only source of information about the disposed of assets.

Examples of records included in the sample follow. In each sample, the study determined that Taxpayer could recognize a SCD loss.

Sample No. 10 - A stated that Taxpayer replaced a HTHW (high temp hot water) system at a location it owned. identified all prior hot water assets as the disposed of assets. The cost history listed the disposed of assets as 39-year property. The replacement asset was 15-year property (asset class 00.4 under Rev. Proc. 87-56, 1987-42 I.R.B. 4) for which Taxpayer claimed bonus depreciation.

Sample No. 77 - stated that Taxpayer converted a leased into . The described costs for clearing and rearranging space. It was unclear if Taxpayer actually disposed of assets, and if so, whether Taxpayer had depreciable basis in the disposed of assets at the leased . treated the earliest assets in the cost history as disposed of assets.

Sample No. 104 - stated that Taxpayer made substantial renovations to a at a leased location. The renovation included updates to the HVAC, plumbing, and electrical systems. Taxpayer's records indicated that the was added between . Pre-Modified Accelerated Cost Recovery System ("pre-MACRS") assets were not listed in the cost history for the location. treated numerous unrelated assets with various PIS dates beginning in as disposed of assets.

Sample No. 135 - stated that Taxpayer installed a humidifier at a leased location because existing portable units were not maintaining sufficient humidity levels. specifically identified 11 water pumps as disposed of assets. It was unclear if Taxpayer actually disposed of water pumps when it installed the humidifier.

Sample No. 162 - A stated that Taxpayer replaced the roof of a building that it owned. Taxpayer's cost history showed a fully depreciated roof in a single asset account. nevertheless used the first-in first-out method to identify numerous disposed of assets with PIS dates between 1994 and 2006, resulting in a SCD loss.

Sample No. 350 - A stated that Taxpayer refurbished an HVAC system at a leased location because the system was old and unreliable. identified a

four-year-old HVAC system as a disposed of asset. Taxpayer's cost histories showed that the four-year-old HVAC system was at different location than project to refurbish an HVAC system.

You reviewed all sampled records that identified as resulting in a SCD loss. You determined that many of the samples did not evidence a SCD loss because of improper application of the proposed regulations under section 168 and Taxpayer's inadequate records. [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

### LAW AND ANALYSIS

The final section 168 regulations (issued in 2014) apply to tax years beginning on or after January 1, 2014 but allow a taxpayer to rely on the proposed section 168 regulations for years beginning on or after January 1, 2012. Treas. Reg. § 1.168-8(j)(3). Because the issue in this case involves tax year , Taxpayer is entitled to rely on the proposed regulations.

Under proposed regulation section 1.168(i)-8, a taxpayer can claim a loss on the disposition of a depreciable asset (or portion of a depreciable asset) that it has not fully depreciated at the time of the disposition. A taxpayer can make a late partial disposition election for tax years between January 1, 2012 and January 1, 2015 by filing an application for a change of accounting method, Form 3115. Rev. Proc. 2014-54, 2014-41 I.R.B. 675 § 3.02.

The proposed section 168 regulations apply to property that a taxpayer depreciates under MACRS. Prop. Treas. Reg. § 1.168(i)-8(a). A taxpayer that disposes of an asset (or a portion thereof) that is MACRS property can claim a loss in the amount of the adjusted depreciable basis of the asset or portion of the asset at the time of the disposition. Prop. Treas. Reg. § 1.168(i)-8(e)(2).

Each building, including its structural components, is an asset. Prop. Treas. Reg. § 1.168(i)-8(c)(4)(ii)(A). An improvement or addition that a taxpayer placed in service after it placed the asset in service is a separate asset. Prop. Treas. Reg. § 1.168(i)-8(c)(4)(ii)(D).

The proposed section 168 regulations apply to leased property if a taxpayer has depreciable basis in leasehold improvements and disposes of those improvements before or at the end of its lease. Prop. Treas. Reg. § 1.168(i)-8(c)(3).

A taxpayer disposes of an asset when it permanently withdraws the asset from use in its trade or business, including by retiring or physically abandoning the asset. Prop. Treas. Reg. § 1.168(i)-8(b)(2).

In the case of a full disposition of an asset in a single asset account, a taxpayer must use the specific identification method of accounting to identify the disposed of asset. Prop. Treas. Reg. § 1.168(i)-8(g)(1). A taxpayer generally must also use the specific identification method to identify the disposed of asset in the case of a partial disposition of an asset in a single asset account. Prop. Treas. Reg. § 1.168(i)-8(g)(1). A taxpayer can use a first-in first-out (“FIFO”) method of accounting to identify the disposed of portion of an asset if the taxpayer cannot determine the year that the asset was placed in service, as could be the case if the taxpayer replaced various sections of a roof over multiple years. Prop. Treas. Reg. § 1.168(i)-8(g)(3), (2). Under the FIFO or modified FIFO method of accounting to identify the disposed of portion of an asset, the new asset and the disposed of portion of the asset must have the same recovery period. Prop. Treas. Reg. § 1.168(i)-8(g)(2)(ii), (iii).

When a taxpayer disposes of a complete asset, the adjusted depreciable basis of the asset at the time of its disposition determines the taxpayer’s gain or loss on the disposition. Prop. Treas. Reg. § 1.168(i)-8(f)(1). A taxpayer that disposes of a portion of an asset can use any reasonable method to determine the unadjusted depreciable basis of the disposed of portion or portions. Prop. Treas. Reg. § 1.168(i)-8(f)(3). The taxpayer must then determine the adjusted depreciable basis of the asset by applying the depreciation method, recovery period, and convention applicable to the asset and accounting for the portion of additional first-year depreciation deduction claimed for the asset that is attributable to the disposed of portion. Prop. Treas. Reg. § 1.168(i)-8(f)(3).

Taxpayer could claim a SCD loss by applying the proposed section 168 regulations to change its method of accounting for dispositions. overstated Taxpayer’s SCD loss for two reasons. First, incorrectly applied the proposed section 168 regulations. Second, Taxpayer’s records do not fully substantiate the losses reported in its study.

The proposed section 168 regulations only apply to MACRS property. Prop. Treas. Reg. § 1.168(i)-8(a). Taxpayer’s cost histories recorded assets that Taxpayer

depreciated under the pre-MACRS method. Taxpayer cannot recognize a SCD loss when it disposes of pre-MACRS assets. Samples that identify pre-MACRS property as the disposed of asset should not be included when calculating Taxpayer's SCD loss. See Sample No. 104.

A taxpayer must actually dispose of an asset (or portion of an asset) to claim a loss on any remaining adjusted depreciable basis. Prop. Treas. Reg. § 1.168(i)-8(b)(2). For multiple samples, assumed that new assets were replacing existing assets. Taxpayer's records, however, indicated that the assets were for an expansion or addition. Samples that did not identify a disposition should not be included in the calculation of Taxpayer's SCD loss. See Sample Nos. 77 and 135.

A taxpayer must use the specific identification method of accounting to identify a completely disposed of asset in a single asset account. A taxpayer also should use that method for partial dispositions unless its records make it impracticable to determine the asset's PIS year. Prop. Treas. Reg. § 1.168(i)-8(g). The study relied on the specific identification method for of the sampled records. When the disposed of asset is replaced by another asset, the replacement asset and the disposed of asset should be in the same location and of the same type. Samples identified assets or portions of assets as disposed of when the described a capital improvement project at a different location or for different types of assets should not be included when calculating Taxpayer's SCD loss. See Sample Nos. 135, 162, and 350.

The proposed section 168 regulations only allow a taxpayer to claim a loss on the disposition of an asset or portion of an asset, including leasehold improvements, in which a taxpayer has adjusted depreciable basis at the time of the disposition. Prop. Treas. Reg. § 168(i)-8(c)(3). assumed that Taxpayer disposed of assets in which Taxpayer had adjusted depreciable basis even when the cost histories did not identify adjusted depreciable basis in assets of the type described . also assumed that Taxpayer had adjusted depreciable basis in assets at leased locations even when the cost histories did not show leasehold improvements related to the types of assets described . Taxpayer leases locations and may have disposed of leased assets in which it had no basis when it conducted a capital improvement project described at a leased location. Additionally, Taxpayer may have fully depreciated buildings and structural components at its owned locations. Samples that do not clearly reflect that Taxpayer disposed of an asset or a portion of an asset with remaining adjusted depreciable basis at the time of the disposition should not be included when calculating Taxpayer's SCD loss. See Sample Nos. 77, 135, and 162.

A taxpayer that disposes of a portion of an asset and cannot determine from its records the year that it placed the asset in service can use a FIFO or modified FIFO method of accounting. Prop. Treas. Reg. § 1.168(i)-8(g)(3). [redacted] relied on a FIFO or modified FIFO method of accounting to identify the asset that Taxpayer partially disposed of for [redacted] of the sampled records. [redacted] identified assets in the cost history for the location of the new asset and treated the assets with remaining adjusted depreciable basis and the earliest PIS dates as the disposed of asset or assets. [redacted] study incorrectly relied on the FIFO method by ignoring single asset accounts with no remaining adjusted basis. Samples that included pre-MACRS assets or that ignored zero-basis assets when determining the disposed of assets should not be included when calculating Taxpayer's SCD loss. See Sample Nos. 104 and 162.

The FIFO method also requires that the new asset and the disposed of asset have the same recovery period. [redacted] identified a SCD loss even when the new asset and the disposed of asset had different recovery periods. Such samples should not be included when calculating Taxpayer's SCD loss. See Sample No. 10.

[redacted] asserted that so long as Taxpayer had remaining adjusted depreciable basis at a location [redacted] improved, the oldest assets could be treated as the disposed of assets even if those assets were unrelated to [redacted] or even if the disposed of assets were fully depreciated. [redacted] treated assets in the cost histories for Taxpayer's buildings and locations as though they were in multiple asset accounts. [redacted] identified the cost basis of the new asset [redacted] and calculated the cost basis of that new asset in [redacted] dollars. [redacted] then identified the earliest MACRS assets in the location's cost history and calculated the cost basis of those assets in [redacted] dollars. [redacted] then compared the new asset's [redacted] cost basis to the old assets' [redacted] cost basis to calculate the adjusted depreciable basis of the old assets (treated as the disposed of assets) and determine Taxpayer's section 481(a) adjustment for a SCD loss. [redacted] cited Prop. Treas. Reg. § 1.168(i)-8(i), Ex. 8 and Ex. 9 for the proposition that if a taxpayer could not identify the disposed of asset, the taxpayer could use a reasonable method to determine the adjusted depreciable basis of a disposed of asset.

We disagree; Example 8 stands for the proposition that a taxpayer can use a reasonable method to identify the disposed of portion of an asset when the taxpayer cannot determine from its records the PIS year of the asset. Once the disposed of portion of the asset is identified, a taxpayer can use a reasonable method to determine the asset's adjusted depreciable basis.



Example 9 stands for the proposition that a taxpayer can use the specific identification method to identify the disposed of portion of an asset and once identified can use a reasonable method to determine the disposed of portion's adjusted depreciable basis.

failed to identify a disposed of asset or disposed of portion of an asset—the first step in determining whether a taxpayer had remaining adjusted depreciable basis in the disposed of asset that would allow a taxpayer to recognize a SCD loss.

In Example 8, the taxpayer could identify the assets as: (1) a building (with 40% of the roof remaining as a structural component); and (2) 60% of a roof (in a single asset account). The taxpayer also could identify the disposed of asset at 55% of the roof, but could not determine if that 55% included the remaining 40% of the original roof (a structural component of the building) or the 60% of the previously replaced roof (in a single asset account). The taxpayer could use the FIFO method to claim a loss when it disposes of 55% of the roof by treating the remaining 40% of the building's roof as a partial disposition of the building asset and treating 15% as a partial disposition of the roof asset. Prop. Treas. Reg. § 1.168(i)-8(i), Ex. 8.

While the disposed of 55% of roof is not specifically identified, the disposed of assets (the roof considered part of the building and the roof in the single asset account) are the same item as the new asset (a roof). Taxpayer cannot install a humidifier and claim a loss by writing off the remaining basis of a roof. Taxpayer must be able to identify the asset that it disposes of or partially disposes of in order to establish that there was in fact a disposition and that Taxpayer had adjusted depreciable basis in the disposed of asset at the time of the disposition.

In Example 9, a building owner identifies an elevator as the disposed portion of the asset and knows the PIS year of the building, but cannot identify the cost of the building's elevators, which are structural components. The owner used a reasonable method to identify the unadjusted depreciable basis of the elevator that it replaced in order to claim a loss on the partial disposition of the building when it replaced the elevator. Prop. Treas. Reg. § 1.168(i)-8(i), Ex. 9. The owner had adjusted depreciable basis in the building, had not replaced any other structural components in the same year and, therefore, could claim a loss on the partial disposition of the building. Example 9 does not permit Taxpayer to compare a new asset's cost basis to the cost basis of the oldest assets in its cost histories to arrive at a SCD loss without first identifying the asset that Taxpayer disposed of or partially disposed of.

A taxpayer that disposes of an entire asset in a single asset account, must first identify the disposed of asset. Prop. Treas. Reg. § 1.168(i)-8(g)(1). If a taxpayer disposes of a portion of an asset, a taxpayer can use a FIFO or modified FIFO method to identify the asset partially disposed of. Prop. Treas. Reg. § 1.168(i)-8(g)(3). Under either the FIFO or modified FIFO method of identifying the partially disposed of asset, a taxpayer must treat the asset with the earliest PIS year that has the same recovery period as the partially disposed of asset. Prop. Treas. Reg. § 1.168(i)-8(g)(2). If a sample included pre-MACRS assets or ignored zero adjusted depreciable basis assets, Taxpayer cannot claim a loss on the disposition or partial disposition of the asset.

A taxpayer can use a reasonable method to determine the unadjusted depreciable basis of the disposed of portion of an asset or an asset in a multiple asset account. Prop. Treas. Reg. § 1.168(i)-8(f)(2), (3). Here, Taxpayer did not account for its assets in multiple asset accounts and, therefore, in the case of a full disposition of an asset, the adjusted depreciable basis of that asset at the time of its disposition determines the SCD gain or loss. Prop. Treas. Reg. § 1.168(i)-8(f)(1). can only use a reasonable method to determine an asset's adjusted depreciable basis if Taxpayer partially disposed of an asset. Taxpayer's various building and structural component assets cannot be treated as though the assets are in a multiple asset account for the purpose of determining the assets' adjusted depreciable basis. study identified groups of the oldest assets as the disposed of assets by comparing a new asset's cost basis to the oldest assets' cost basis. To the extent applied this method, the sample should be disallowed in calculating Taxpayer's SCD loss. See Sample Nos. 77, 104, and 162.

We coordinated this advice with the Office of Associate Chief Counsel (Income Tax & Accounting). Please call at if you have any further questions.

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By: \_\_\_\_\_

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