ABOUT KBKG

SOLUTIONS FOR TAX PROFESSIONALS AND BUSINESSES
Tax Credits • Incentives • Cost Recovery

Established in 1999 with offices across the US, KBKG provides turn-key tax solutions to CPAs and businesses. By focusing exclusively on value-added tax services that complement your traditional tax and accounting team, we always deliver quantifiable benefits to clients.

Our firm provides access to our knowledge base and experienced industry leaders. We help determine which tax programs benefit clients and stay committed to handling each relationship with care and diligence. Our ability to work seamlessly with your team is the reason so many tax professionals and businesses across the nation trust KBKG.

SERVICES OVERVIEW

Research & Development Tax Credits

Federal credit worth approximately 10% of every qualified dollar spent on developing brand new or improving existing products, processes, software, and formulae.

Cost Segregation for Buildings and Improvements

Any building improvement over $750,000 should be reviewed for proper classification of the individual components for tax depreciation, and retirement purposes.

45L Credits for Energy Efficient Residential Developments

Newly constructed or renovated apartments, condos, and tract home developments that meet certain criteria are eligible for a $2,000 credit per unit.

179D Incentive for Energy Efficient Commercial Buildings

Federal deduction worth $1.80 per square foot of energy-efficient buildings. Available to architects, engineers, design/build contractors and building owners.

IC-DISC

The Interest Charge Domestic International Sales Corporation (ICDISC) offers significant Federal income tax savings for making or distributing U.S. products for export. IC-DISC benefits are available to qualified producers or distributors that are either directly involved in exporting, or selling products to distributors or wholesalers who resell for use outside of theU.S.

Transfer Pricing Services

The cross-border transfer prices of goods, royalties, services, and loans drive how much income tax a multinational company pays by country. We assist US and international companies in establishing, documenting, and defending transfer pricing practices for the IRS and international tax authorities.

Fixed Asset Review

While a cost segregation study focuses on buildings, a comprehensive Fixed Asset Tax Review encompasses all fixed assets a company owns including real property, machinery, furniture, fixtures, and equipment.

Repair vs. Capitalization Review §263(a)

Taxpayers often capitalize major building expenditures that should be expensed as repairs and maintenance such as HVAC units, roofs, plumbing, lighting and more. Retirement loss deductions for demolished building structural components are also identified.

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INDUSTRY MATRIX FOR TAX SAVING OPPORTUNITIES

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At KBKG, we are committed to identifying all possible tax saving opportunities for our clients and CPA partners. Our detailed Industry Matrix helps quickly determine which tax credits and deductions apply by industry at a glance. Our chart alone provides some insight to ensure that businesses are seeking out all potential benefits; however, KBKG's certified engineers and technical experts perform a thorough assessment during the engagement process to be sure all possible incentives are identified and considered.

INDUSTRY	R&D TAX CREDITS	REPAIR/ ASSET RETIREMENT	45L TAX CREDITS	179D TAX DEDUCTIONS	COST SEGREGATION / FIXED ASSET	IC-DISC	*TRANSFER PRICING	EMPLOYEE RETENTION TAX CREDIT
Affordable Housing		✓	✓	✓	✓			✓
Agriculture, Forestry & Fishing	✓				✓	✓	✓	✓
Architecture & Engineering	✓			✓	✓	✓		✓
Auto Dealerships		✓		✓	✓			✓
Cannabis	✓				✓			✓
Communications & Utilities	✓	✓			✓	✓		✓
Construction	✓				✓			✓
Film & Music	✓				✓	✓	✓	✓
Financial Services	✓	✓			✓		✓	✓
Government Contractors	✓			✓	✓	✓		✓
Healthcare	✓	✓		✓	✓		✓	✓
Home Builder			✓					✓
Hotels	✓	✓		✓	✓		✓	✓
Manufacturing & Distribution	✓	✓		✓	✓	✓	✓	✓
Mining	✓				✓	✓	✓	✓
Multifamily Developers		✓	✓	✓	✓			✓
Oil & Gas	✓	✓			✓		✓	✓
Pharmaceutical	✓	✓		✓	✓	✓	✓	✓
Professional Services	✓	✓			✓		✓	✓
Real Estate		✓		✓	✓			✓
Restaurants		✓			✓			✓
Retail	✓	✓		✓	✓			✓
Technology/Software	✓				✓	✓	✓	✓
Transportation	✓				✓		✓	✓
Wholesale Trade	✓	✓		✓	✓	✓	✓	✓

**May apply to any industry as long as the company has cross border subsidiaries. Industries indicated are more likely to have multinational business.*

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IDENTIFYING VALUE-ADDED TAX OPPORTUNITIES

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KBKG SERVICE	DESCRIPTION & HIGHLIGHTS	APPLICABLE CLIENTS & INDUSTRIES	HOW MUCH IS IT WORTH?	TAX CONSIDERATIONS
RESEARCH & DEVELOPMENT TAX CREDITS (FEDERAL & STATE)	Federal and State tax credit – designed to promote innovation. Expenses incurred in the United States and that meet the qualification criteria can result in a credit. Qualifying expenses can include wages paid to employees, supplies used in the research process, and payments made to contractors for performing qualified research.	Clients developing brand new products, processes, software, or formula. Clients materially improving existing products, processes, software or formula. Clients that employ those with technical backgrounds including: • Manufacturing • Software Development • Architecture • High Tech • Food & Beverage • Equipment or tools • Life Sciences • Agriculture	**Federal Benefit - Roughly 10% of their total Qualified R&D Expenses** Ex.: Client has $1M/year of wages related to R&D. Benefit = $100k in gross credits per year. Many states also allow an R&D credit. For example, CA R&D Credit is worth an additional 7.5% of Qualified R&D expenses.	• Dollar-for-dollar reduction in income tax liabilities. • 1-year carryback / 20-year carryforward of unused credits. • Qualified small businesses can reduce alternative minimum tax liabilities. • Qualified start-up companies can offset up to $250,000 in payroll taxes.
COST SEGREGATION (FEDERAL & STATE)	Allows **taxpayers who have constructed, purchased, expanded, or remodeled any kind of real estate** to accelerate depreciation deductions by reclassifying building components into shorter tax lives.	Any **building with over $750k** of depreciable tax basis (excluding land). Any **leasehold improvement with over $500k** of depreciable tax basis (excluding land). Any smaller **residential rental property with over $150k** of depreciable tax basis (excluding land) can utilize KBKG's online software to generate a cost segregation report.	Net Present Value is roughly **5% of the total building cost.** Ex.: $2M office can yield an after-tax NPV of $100k.	• Reduces AMT • Starting in 2018, unused deductions carryforward. • Must recapture personal property and bonus eligible assets upon the sale of a building.
TRANSFER PRICING (INTERNATIONAL)	Federal credit for developers of **apartments, condos, or spec homes** that meet The transfer prices of goods, royalties, services, and loans drive how much income tax is paid by country. Corrections to transfer pricing may lead to significant improvements in a company's global effective tax rate. Savings dependent on differences in tax rates between countries and can be significant. Tax reform provides incentives for companies to generate income in the US with lower rates certain energy efficiency standards. Units must be certified by a qualified professional to be eligible.	All US and foreign-owned multinational companies. Transfer pricing rules apply to goods, services, royalties, loans and other cross-border transactions in all industries Companies with supply chain restructuring programs, new R&D facilities, or international subsidiaries are often best placed to realize benefits.	US tax reform has created opportunities to improve global effective tax rates through changes to transfer prices, e.g. • Foreign Derived Intangible Income ("FDII") allows C-Corporations to pay a 13.125% rate on some export income • Changes to transfer prices of imported goods may also lead to tax savings at the 21% rate. • Substantial benefits when correcting transfer pricing to utilize tax net operating losses.	Companies without transfer pricing documentation can face additional tax, interest, non-deductible penalties and double tax for all open tax years. Tax authorities are concerned about multinational companies paying their "fair share" of income tax in each country where they operate.

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IDENTIFYING VALUE-ADDED TAX OPPORTUNITIES

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KBKG SERVICE	DESCRIPTION & HIGHLIGHTS	APPLICABLE CLIENTS & INDUSTRIES	HOW MUCH IS IT WORTH?	TAX CONSIDERATIONS
RESIDENTIAL ENERGY CREDITS / SECTION 45L (FEDERAL / STATES CAN HAVE SIMILAR PROGRAMS)	Federal credit for developers of **apartments, condos, or spec homes** that meet certain energy efficiency standards. Units must be certified by a qualified professional to be eligible.	Anyone that has built apartments, condos or production home developments (3 stories or less), in the last 4 years. **Generally, more than 20 units.**	**Federal credit = $2,000 per apartment/home unit.** **Many states have similar credits.** Ex.: 100-unit apartment/ condo can get $200,000 of Federal Tax Credits.	• Credit is realized when unit is first leased or sold, not placed in service. • 1-year carryback • 20-year carryforward. • Does not reduce AMT. • Subject to passive activity loss rules • Credit reduces basis.
COMMERCIAL ENERGY DEDUCTIONS / SECTION 179D (FEDERAL/ STATES CAN HAVE SIMILAR PROGRAMS)	Federal deduction for **architects, engineers, and design/build contractors** that work on public or government buildings such as schools, libraries, courthouses, military housing etc. **Also available to any commercial building owner.**	• **179D for designers:** Architects, general contractors, engineers, electrical & HVAC subcontractors. • **Any building owner or lessee:** That has constructed a commercial improvement greater than 50,000 SF since 1/1/2006.	**$.30 up to $1.80 per square foot in federal tax deductions.** Ex.: 100,000SF building is eligible for $180,000 in deductions.	• Reduces AMT • Deduction reduces basis in real property. • Designers must amend open tax years to claim. • Owners can go back to 2006 with Form 3115 to claim missed deductions.
FIXED ASSET TAX REVIEW (FEDERAL)	Comprehensive review of a company's entire fixed asset listing and supporting documents to assign appropriate tax lives, identify retirements, and correct items that should be expensed. Includes cost segregation and repair analysis.	Operations with > $40M in real property or > 500 lines of fixed assets. • Retail, restaurant, bank and hotel chains of 10 or more • Manufacturing • Utility companies	Net present value (NPV) of 5-8% of total building-related costs. Ex.: Manufacturing client has $60M of 39-year fixed assets. NPV Cash value = $3M -$4.8M	• Reduces AMT • Starting in 2018, unused deductions carryforward. • Must recapture personal property and bonus eligible assets upon the sale of a building.
REPAIR V. CAPITALIZATION REVIEW "ASSET RETIREMENT STUDY" (FEDERAL)	New rules allow you to assign value to "structural" components removed from a building and write off the remaining basis. Regs also clarify repair expense treatment of many types of building costs such as HVAC or roof replacements. KBKG also provides compliance consulting for repair and disposition regulations.	**Any building renovation costs > $400k** **Retirement Study -** Building is renovated AFTER owning it at least 1 year. Building should have **<u>> $500K of remaining depreciable basis left.</u>** **Repair Study** - renovations that include **roof, HVAC, windows, lighting, plumbing, ceilings, drywall, flooring, etc.**	Additional Year 1 deductions of **15%-40% of renovation costs (on top of benefits from 1245 reclassification)** Ex.: Client spends $3M on structural renovations. Additional Year 1 deductions of $450K-$1.2M.	• Depending on project specifics, may require a separate 3115 if doing concurrently with a depreciation change.
IC-DISC FEDERAL INCOME TAX INCENTIVE (FEDERAL)	The IC-DISC provides significant and permanent tax savings for producers and distributors of U.S.-made products and certain services used abroad.	**Any closely held, privately owned business with over $250,000 in profits from exports** • Manufacturers • Distributors • Architects & Engineers • Agriculture and Food Producers • Software Developers • Other Producers	Minimum permanent **17% decrease in tax rate on half of export profits.** Benefits can be dramatically higher by performing a transaction-by-transaction analysis.	• Requires annual filing 1120 IC-DISC. • No changes to business operations. • Benefits begin when entity is formed.

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Qualified Improvements - Depreciation Quick Reference (updated 3/30/2020)

	Applicable PIS Dates (inclusive)	MACRS GDS Recovery Period	Bonus Dep Eligible	3 Year Rule	Unrelated Parties Rule	179 Expense Eligible	Important Notes	Code Section
Qualified **Improvement** Property (QIP): 2018 - Onward	01/01/18 - onward	15 Year / SL	Y	N	N	Y [9]	Applies to interior common areas. Building can be owner occupied. No 3-year rule. See exclusions in definition.	168(e)(6)
Qualified **Improvement** Property (QIP): 2016 - 2017	1/1/16 - 12/31/17	39 [5] Year / SL	Y	N	N	N [7]	Applies to interior common areas. Building can be owner occupied. No 3-year rule. See exclusions in definition.	168(k)(3)
Qualified **Leasehold** Improvements (QLI): 2004 - 2017	10/23/04 - 12/31/17	15 Year / SL	Y [1]	Y	Y	2010 - 2017 [6]	Landlord or lessee can make the interior improvement. See exclusions in definition.	168(e)(6)
Qualified **Leasehold** Improvements (QLI): 2001 - 2004 Partial	9/11/01 - 10/22/04	39 Year / SL	Y	Y	Y	N/A	39 year QLI qualifies for Bonus. Landlord or lessee can make the interior improvement. See exclusions in definition.	168(e)(6)
Qualified **Retail** Improvement Property: 2016 - 2017	1/1/16 - 12/31/17	15 Year / SL	Y	Y	N	2010 - 2017 [6]	Building can be owner occupied. See exclusions in definition.	168(e)(8)
Qualified **Retail** Improvement Property: 2009-2015	1/1/09 - 12/31/15	15 Year / SL	N [2]	Y	N	2010 - 2017 [6]	Building can be owner occupied. See exclusions in definition.	168(e)(8)
Qualified **Restaurant** Property: 2009 - 2017	1/1/09 - 12/31/17	15 Year / SL	N [4]	N	N	2010 - 2017 [6]	Encompasses the entire building structure as well as interior costs. Can be an acquired building.	168(e)(7)
Qualified **Restaurant** Property: 2008	1/1/08 - 12/31/08	15 Year / SL	Y	Y	N	N/A	Applicable to all improvements attached to building.	168(e)(7)
Qualified **Restaurant** Property: 2004-2007	10/23/04 - 12/31/07	15 Year / SL	N [3]	Y	N	N/A	Applicable to all improvements attached to building.	168(e)(7)

Bonus Depreciation Rates (inclusive dates)

9/11/01 - 5/5/03 [8]	30%
5/6/03 - 12/31/04 & 1/1/08 - 9/8/10 [8]	50%
9/9/10 - 12/31/11 [8]	100%
1/1/12 - 9/27/17 [8]	50%
9/28/17 - 12/31/22 [8, 10, 11]	100%
1/1/23 - 12/31/23 [8, 10, 11]	80%
1/1/24 - 12/31/24 [8, 10, 11]	60%
1/1/25 - 12/31/25 [8, 10, 11]	40%
1/1/26 - 12/31/26 [8, 10, 11]	20%

Footnotes:

1) NOT eligible for bonus if placed in service 1/1/2005 - 12/31/2007.

2) Retail Improvements are not eligible for bonus depreciation unless it meets the criteria for QLI.

3) Qualified Restaurant Property is eligible for bonus depreciation if placed in service 10/23/2004 - 12/31/2004.

4) Improvements that also meet the criteria for QLI are eligible for bonus depreciation. After 2015, improvements that also meet the criteria for QIP are eligible for bonus depreciation. Restaurant property that is acquired 9/28/2017-12/31/2017 is fully expensed (subject to written binding contract rules).

5) Improvements that meet the definition of Qualified Improvement Property and meet the definition of QLI , Qualified Retail Improvements, or Qualified Restaurant Property can be depreciated over a 15-year straight line period.

6) Eligible up to $250k from 2010 - 2015; 2016 and 2017 are subject to normal 179 expense cap.

7) Improvements that meet the definition of Qualified Improvement Property and meet the definition of QLI , Qualified Retail Improvements, or Qualified Restaurant Property qualify for the 179 Expense.

8) Long Production Period (QLIs over $1M and construction period exceeds 1 year) - can be placed in service one year after bonus normally expires. QLI (that is also LPP) started before 1/1/2012 can be entirely eligible for 100% bonus if completed during 2012. Bonus is applicable if LPP is started before 1/1/2027. Only pre-1/1/2027 basis is bonus eligible on any LPP.

9) Section 179 rules are modified to include certain improvements to buildings. See 179 Expense notes on page 2.

10) Bonus depreciation is available for used property placed in service after 9/27/17, however it is does not apply to the portion where the taxpayer previously had a depreciable interest.

11) Bonus is not available to taxpayers with floor plan financing (motor vehicle, boat, farm machinery) unless they are exempt from business interest limitations.

Section 179 Expense Limitations (Dates, Dollar Limit, Reduction)		
01/01/11 - 12/31/17	$500,000	$2,000,000
1/1/18 onward [1]	$1,000,000 [2]	$2,500,000 [2]

Footnotes:

1) In 2018 onward, the Section 179 expense includes improvements to the following non-residential real property that are placed in service after the date such property was first placed in service: roofs; heating, ventilation, and air-conditioning; fire protection and alarm systems; and security systems. 179 expensing does not apply to certain non-corporate lessors. See Sec. 179(d)(5)

Qualified Section 179 property now includes depreciable tangible personal property used to furnish lodging (e.g. residential rental properties, hotels, etc).

2) Any taxable year beginning after 2018, the dollar amounts will be indexed for inflation.

Definitions:

3 Year Rule: The improvements must have been placed in service by any taxpayer more than three years after the date the building was first placed into service.

Leased Between Unrelated Party Qualification: Improvements must be made subject to a lease between unrelated parties (see code section 1504). Can be made by lessees, sub-lessees or lessors to an interior portion of a nonresidential building. Parties are related when there is more than 80% ownership shared between them.

Long Production Period Property: 168(k)(2)(B) - Must have a recovery period of at least 10 years, is subject to section 263A, has an estimated production period exceeding 2 years, or an estimated production period exceeding 1 year and a cost exceeding $1,000,000.

Qualified leasehold improvement property (QLI)[A] 2001-2017 (A) Any improvement to an interior portion of a building which is nonresidential real property if— (i) such improvement is made under or pursuant to a lease (I) by the lessee (or any sublessee) of such portion, or (II) by the lessor of such portion, (ii) such portion is to be occupied exclusively by the lessee (or any sublessee) of such portion, and (iii) such improvement is placed in service more than 3 years after the date the building was first placed in service. (B) Certain improvements not included. Such term shall not include any improvement for which the expenditure is attributable to— (i) the enlargement of the building, (ii) any elevator or escalator, (iii) any structural component benefiting a common area, and (iv) the internal structural framework of the building.

Qualified retail improvement property[A] 2009-2017: Any improvement to an interior portion of a building which is nonresidential real property if— (i) such portion is open to the general public and is used in the retail trade or business of selling tangible personal property to the general public, and (ii) such improvement is placed in service more than 3 years after the date the building was first placed in service. QRIP shall not include any improvement for which the expenditure is attributable to— (i) the enlargement of the building, (ii) any elevator or escalator, (iii) any structural component benefitting a common area, or (iv) the internal structural framework of the building.

Qualified restaurant property[B] 2004-2008: an improvement to a building if— (A) Such improvement is placed in service more than 3 years after the date such building was first placed in service, and (B) more than 50 percent of the building's square footage is devoted to preparation of, and seating for on-premises consumption of, prepared meals.

Qualified restaurant property[B] 2009-2017 Any section 1250 property which is (i) a building or improvement to a building — if more than 50 percent of the building's square footage is devoted to preparation of, and seating for on-premises consumption of, prepared meals, and (ii) if such building is placed in service after December 31, 2008

Qualified improvement property[A] (QIP) 2016-2017: (A) Any improvement to an interior portion of a building which is nonresidential real property if such improvement is placed in service after the date the building was first placed in service. (B) Certain improvements not included. Such term shall not include any improvement for which the expenditure is attributable to— (i) the enlargement of the building, (ii) any elevator or escalator, (iii) the internal structural framework of the building.

Qualified improvement property[A] (QIP) 2018-onward: (A) Any improvement *made by the taxpayer* to an interior portion of a building which is nonresidential real property if such improvement is placed in service after the date the building was first placed in service. (B) Certain improvements not included. Such term shall not include any improvement for which the expenditure is attributable to— (i) the enlargement of the building, (ii) any elevator or escalator, (iii) the internal structural framework of the building.

Other notes:

A) Tenant improvements that include costs for HVAC rooftop units are excluded from the definition of Qualified Leasehold Improvements (QLI), Qualified Retail Improvements, and Qualified Improvement Property (CCA 201310028)

B) Restaurant tenant improvements located within a multi-tenant building where 50 percent of the building's total square footage is not leased to restaurants, do not meet the definition of Qualified Restaurant Property.

KBKG REPAIR VS. CAPITALIZATION:
IMPROVEMENT DECISION TREE - FINAL REGULATIONS

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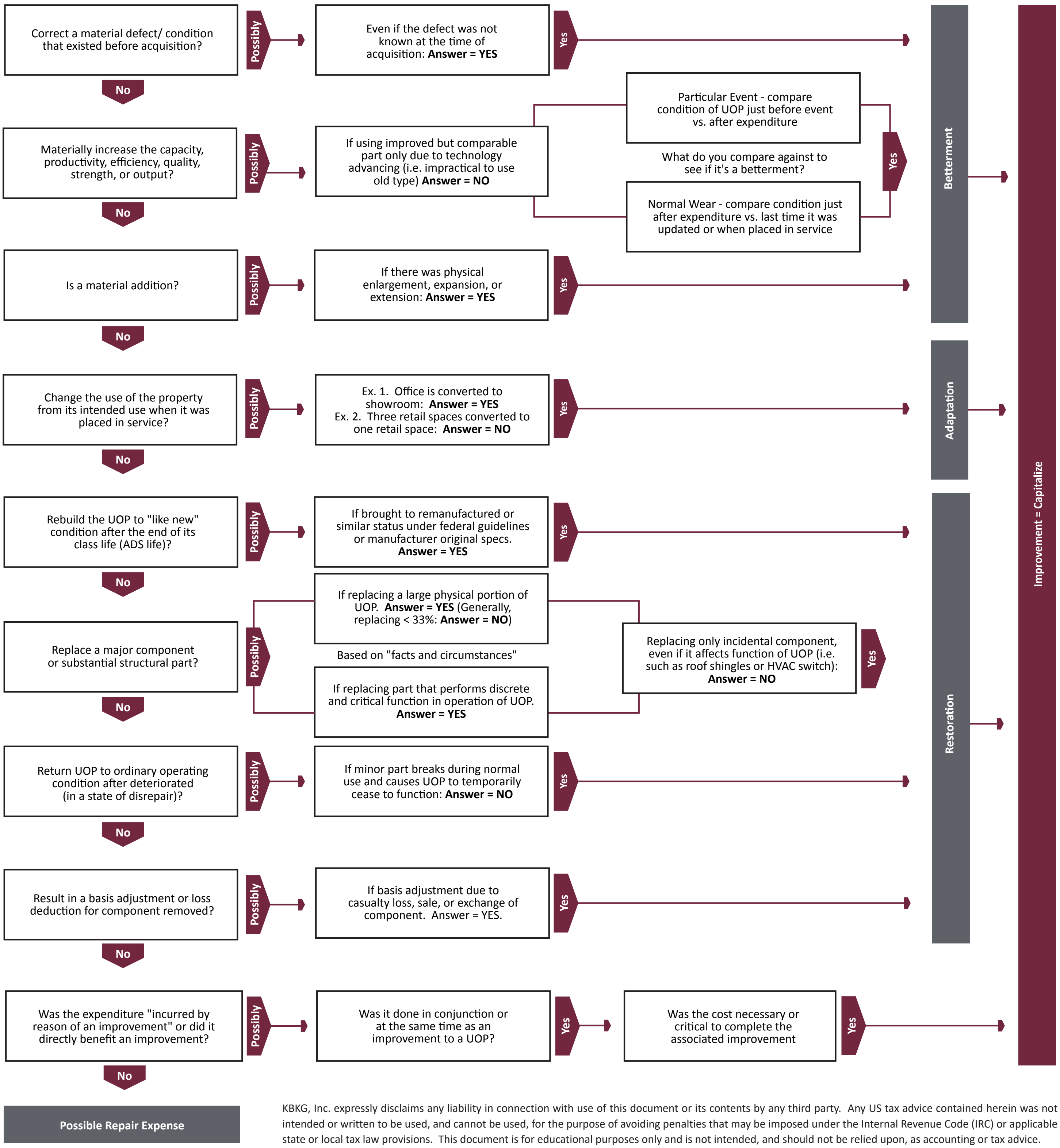
Considering the appropriate Unit of Property (UOP), does the expenditure: (Last Updated 3-20-2015)



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KBGK BUILDING UNIT OF PROPERTY & MAJOR COMPONENTS CHART

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This chart was created to help users identify building systems & typical "major components" in real estate assets. Replacing a major component is a capital expenditure while replacing an incidental component can be expensed

BUILDING STRUCTURE	LAND IMPROVEMENTS	HVAC SYSTEM	ELECTRICAL SYSTEM	PLUMBING SYSTEMS
• Roof system (membrane, insulation and structural supports) • Foundation • Other structural load-bearing elements, including stairs • Exterior wall system • Ceilings • Floors • Doors • Windows • Partitions • Loading docks	• Landscaping (shrubs, trees, ground cover, lawn, irrigation) • Storm drainage (inlets, catch basins, piping, lift stations) • Site lighting (pole lights, bollard lights, up lights, wiring) • Hardscape (retaining walls, pools, water features) • Site structures (gazebos, carports, monument signs) • Paving (roads, driveway, parking areas, sidewalks, curbing)	• Heating system (boilers, furnaces, radiators) • Cooling system (compressors, chillers, cooling towers) • Rooftop packaged units • Air distribution (ducts, fans, etc.) • Piping (heated, chilled, condensate water)	• Service and distribution (panel boards, transformers, switchgear, metering) • Lighting (interior and exterior building mounted) • Site electrical utilities • Branch wiring (outlets, conduit, wire, devices etc.) • Emergency power systems	• Plumbing fixtures (sinks, toilets, tubs etc.) • Wastewater systems (drains, waste and vent piping) • Domestic water (supply piping and fittings) • Water heaters • Site piping utilities

FIRE PROTECTION SYSTEM	SECURITY SYSTEM	GAS DISTRIBUTION SYSTEM	ESCALATORS	ELEVATORS
• Sprinkler systems (piping, heads, pumps) • Fire alarms (detection and warning devices, controls) • Exit lighting and signage • Fire escapes • Extinguishers and hoses	• Building security alarms • (detectors, sirens, wiring) • Building access and control systems	• Gas piping including to/ from property line and other buildings	• Stairs and handrails • Drive systems (motors, truss, tracks)	• Elevator cars • Drive systems (motors, lifts, controls) • Suspension systems (counterweights, framing, guide rails)

* Building unit of property (UOP) rules apply to each building structure located on a single property.
** Building system components with a different tax life are separate units of property. For example, a cost segregation study separating HVAC into 5-year & 39-year categories for a restaurant creates two separate HVAC units of property.

Lessee of Building: Must apply the same units of property above but only to the portion of the building being leased.
Personal Property: UOP are parts that are "functionally interdependent" (i.e. placing one part in service is dependent on placing the other part in service).
Plant Property: UOP is each component that performs a discrete and critical function. Generally, each piece of machinery or equipment purchased separately.
Network Assets: UOP is determined by taxpayer's particular facts

Definitions

Plant Property: Machinery and equipment used to perform an industrial process such as manufacturing, generation, warehousing, distribution, automated materials handling, or other similar activities.
Network Assets: Railroad track, oil and gas pipelines, water and sewage pipelines, power transmission and distribution lines, telephone and cable lines; -- owned or leased by taxpayers in each of those respective industries.
Major Component: Part or combination of parts that performs a discrete and critical function in the operation of the unit of property.
Incidental Component: Relatively small, inexpensive, or minor part that performs a discrete and critical function for the UOP. Generally, not capitalized because of its size, cost, or significance.

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BEFORE WE GET STARTED

Welcome and thank you for joining KBKG's live webinar

- We will start the live webinar at **1pm PT | 4pm ET**
- For the best audio, dial in using the telephone number provided
- Please enter questions into the Q&A module
- Download the slides from **KBKG.com/resources**
  - "Updates to the Final Tangible Property Repair Regulations"

KBKG

RC 103:
The Final Tangible Property Repair Regulations and Fixed Asset Review:
Opportunities for 2023 and Beyond

Download PowerPoint slides from **KBKG.com/resources**

All attendees are muted.

The webinar will begin promptly at 1 PM Pacific / 4 PM Eastern

RC 103:

Tangible Property Repair Regulations:

Opportunities for 2023 and Beyond

JOHN MANOLOS

Senior Manager – Cost Segregation

ADMINISTRATIVE

AUDIO

- For the best sound, you should dial in and use the provided telephone number for audio.

HANDOUT MATERIALS

- Download power point slides from KBKG.com/resources

CPE (Continuing Professional Education)

- Answer all polling questions during the webinar

QUESTIONS AND ANSWERS

- Please submit your questions and we will answer as many as time permits.

ABOUT KBKG

- Established in 1999 with offices across the U.S. , including Pasadena, New York, Chicago, Dallas/Ft. Worth, and Atlanta.
- Provide turn-key tax solutions to CPAs and businesses.
- R&D Tax Credits, R&D Audit Defense, Cost Segregation, Energy Tax Incentives, Repair vs. Capitalization Studies, Transfer Pricing, IC-DISC Export Incentives.
- Performed thousands of tax projects resulting in over a billion dollars in benefits for our clients.
- Our team is a diverse mix of tax professionals, attorneys, engineers, and economists from various disciplines. This combination of talent allows us to focus on our areas of service and maximize results for our clients.
- A preferred provider for thousands of CPAs across the country.

John Manolos

- Member of Firm’s National Tax Practice
- Member of the American Society of Cost Segregation Professionals
- 15+ years of practice in Cost Segregation
- Bachelor's degree in Engineering Technology from California State University, Pomona
- Masters in Taxation from Golden Gate University

LEARNING OBJECTIVES

Upon completion of this course, you will have learned about:

- The significance of the Unit of Property and the eight prescribed building systems
- The definition of an Improvement and how to evaluate using the BAR test
- How to apply the tangible property regs to building components
- How recognizing retirements creates permanent tax savings
- What the routine maintenance safe harbor is and how it applies to buildings
- When the safe harbor for small taxpayers and the de minimis rule are applicable
- How the retail/restaurant industry safe harbor works and when it's useful

TANGIBLE PROPERTY REGULATIONS

- Effective for all taxpayers (other than "small qualifying taxpayers") for tax years beginning on or after January 1, 2014

- Provide rules for distinguishing between a currently deductible repair and a capitalized expenditure

- Sec. 1.263-1, -2, and -3 ("Repair" regulations)
- Sec. 1.68(i)-1 and -7 (rules relating to GAA & MAA)
- Sec. 1.168(i)-8 ("Disposition" regulations)

- Compliance generally adopted via a Form 3115 *Application for Change in Accounting Method* and Sec. 481(a) adjustment calculation

THE TANGIBLE PROPERTY REGULATIONS: REPAIR V. CAPITALIZATION

- Determination is “highly factual”
- Guidance revolves around what constitutes the Unit of Property that is being repaired or improved.
- Must analyze each cost in the context of the <u>“Unit of Property”</u>
  - Ex. $30,000 cost for 5 new plumbing fixtures where Unit of Property (plumbing system) = small 5,000SF building; likely a capital improvement.
  - $30,000 cost for 5 same new plumbing fixtures where Unit of Property (plumbing system) = large 50,000SF building; more likely a repair.
  - Same items replaced, but facts and circumstances require a different treatment!
- Smaller the Unit of Property, more likely to capitalize

WHAT IS THE UNIT OF PROPERTY (UOP)?

- **Functional Interdependence** test – all the components that are functionally interdependent comprise a single UOP.

- Components are functionally interdependent if the placing in service of one component is dependent on placing in service other components

Special Rules

- Plant Property
- Network Assets
- Buildings
- Leasehold Improvements, Condo's, Co-op

POLLING QUESTION #1

BUILDINGS: WHAT IS THE UNIT OF PROPERTY (UOP)?

- Building and its structural components is a single UOP §1.263(a)-3(e)(2)(i)

- Building structure consists of "building and its structural components other than the structural components designated as ***building systems*** …" §1.263(a)-3(e)(2)(ii)(B)

1. **HVAC**
2. **Plumbing systems**
3. **Electrical systems**
4. **All Escalators**
5. **All Elevators**
6. **Fire Protection & Alarm Systems**
7. **Security systems**
8. **Gas distribution systems**
9. **REST OF BUILDING**
   Walls, roof, floors, ceilings, windows, doors, finishes, structure, etc..

LEASED BUILDINGS - UOP

Lessor – entire building UOP

- For multi-tenant buildings, UOP is always the entire building
- Must still evaluate “building systems”

Lessee – UOP is portion of the building that is leased.

- For multi-tenant buildings UOP is their space
- Combine all future improvements to leased portion into the UOP being leased. Must still evaluate “building systems”

Example: A <u>lessee</u> in large building remodels bathroom in their office. The expenditure is likely a capital improvement because work was done on a <u>major portion of the plumbing system located within their office space</u>.

- However, if <u>lessor</u> performed the same work, it might be a repair because work only affected <u>small amount of the building's entire plumbing system.</u>

WHAT IS AN IMPROVEMENT?

An "improvement" is defined under §1.263(a)-3(d) as an amount paid after the property is placed in service which:

- Is a **Betterment** to the UOP
- **Adapts** the UOP to a new or different use
- **Restores** the UOP

B-A-R = Improvement (Capitalize)

WHAT IS A BETTERMENT?

- Corrects a material condition or defect
- Is a material addition (enlargement, expansion, extension)
- Is a material increase in capacity, productivity, efficiency, strength, quality, or output (e.g., replace asphalt shingles with new solar shingles)
  - Enhancement due to technological advancements not necessarily betterment. (e.g., HVAC equipment is always going to be more efficient. Is it comparable?)
- "Material" - IRS has not defined this and may be an area of controversy.

WHAT IS AN ADAPTATION?

If you adapt something to new use it must be capitalized as an improvement

Example: A taxpayer converts its manufacturing building into a showroom for its business.

- Replaces some lights, paints walls, and replaces other components to provide better layout for showroom and offices
- Taxpayer must capitalize

KBKG Comment: If they only did those items for their manufacturing operation, it may qualify as a repair deduction if it satisfies all other requirements are met.

WHAT IS A RESTORATION?

Restoration only if:

- Replacement of **<u>major component or substantial structural part</u>** of a UOP
- Returns UOP to ordinary operating condition – if in state of disrepair & no longer functional
- Rebuilds UOP to like-new condition after end of class life
    - Class life - alternative depreciation system
- Replaces component deducted as loss; or adjusted basis taken into account for loss/gain
- Repair component after casualty loss/event if basis adjusted

WHAT IS A RESTORATION?

Major Component: Parts that Perform a discrete and critical function for the building system or UOP

- Example: Lighting, air conditioning, flooring, water heater etc…

Substantial Structural Part: large physical portion of building system or UOP

- Example: Replacing more than 50% of the lighting

Consider all facts and circumstances – both quantitative & qualitative

- Not just the cost, but the size, type, function etc.

FINAL REGS: Replacement of "incidental component" of UOP will not constitute a major component even though it affects the function of the UOP

- Example: HVAC Thermostat Controls

RESTORATION EXAMPLES

Final Regs: restoration standards must be applied to all major components of the building or UOP

- Must first identify the major component of a building system. Then see if a significant portion was replaced.

Example: Office building HVAC System comprised of 3 furnaces, 3 AC units, and duct work throughout the building

- 1 furnace breaks down, replaced with a new furnace
- 3 furnaces together perform critical function for HVAC system
- 3 furnaces = major component
- However replacing a single furnace (33%) is not a significant portion of the major component
- Not a restoration

RESTORATION EXAMPLES – HVAC SYSTEMS

Example: Office building with one HVAC System

- Comprised of 1 chiller, 1 boiler, cooling tower, etc.
- Chiller is replaced with comparable unit
- Chiller functions to cool water to generate AC
- Chiller performs a discrete and critical function of HVAC system
- Must Capitalize

Assume same as above except there were 4 chillers and only one was replaced.

- Repair expense

RESTORATION EXAMPLES – HVAC SYSTEMS

Example: Office HVAC has 10 roof top units for different areas

- Controls allow for distribution of heat or A/C to various spaces
- Building experienced climate control problems in various offices
- Owner replaced 3 of the roof mounted units
- 10 units are a major component of HVAC system
- Replacement of the 3 units:
  - Not a significant portion of the major component
  - Not a substantial structural part of HVAC system
- Not a restoration. If also not a betterment, Repair Expense

New items can be expensed under Sec. 179 including: Roofs, HVAC, fire protection, alarm systems, and security systems

POLLING QUESTION #2

KBKG GUIDE TO ROOFING

First determine the Unit of Property

- **REST OF BUILDING (Shell)**
  Walls, roof, floors, ceilings, windows, doors, finishes, structure, etc..

Next, determine the "substantial structural part" or "major component"

- Roof System

Finally, analyze…

Guide to Expensing Roofing Costs – article in The Tax Advisor:

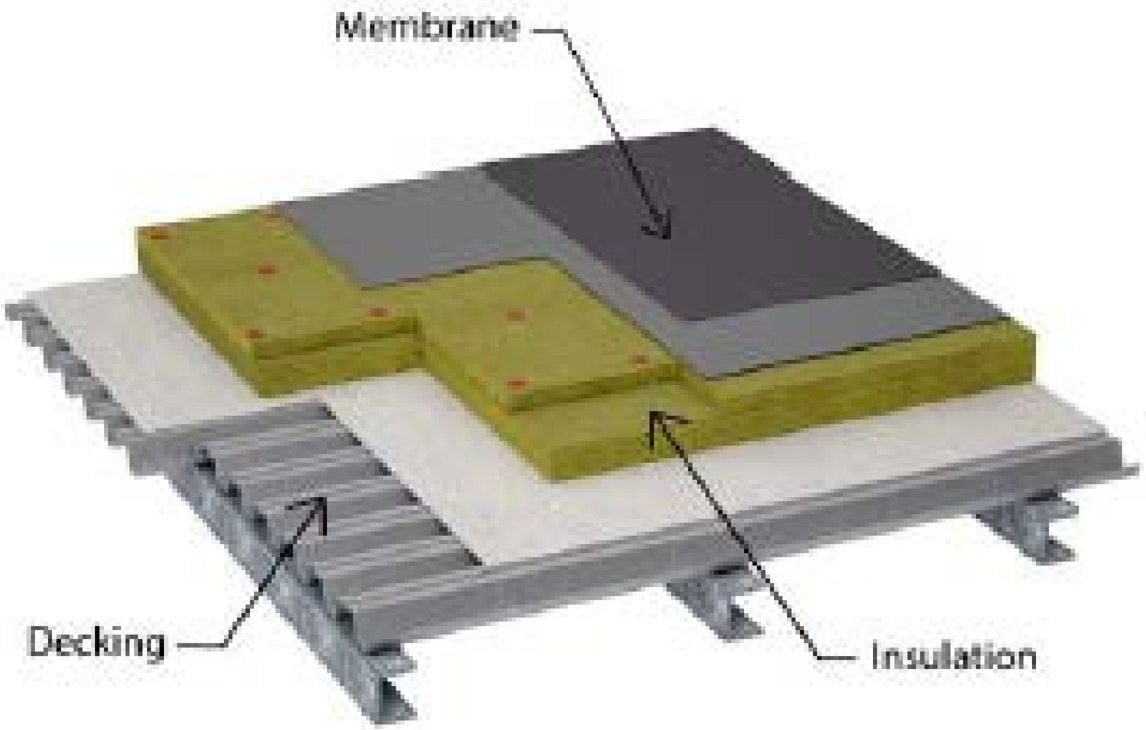
- https://www.kbkg.com/news/kbkg-tax-insight-guide-to-expensing-roofing-costs

New items can be expensed under Sec. 179 including: Roofs, HVAC, fire protection & alarm systems, and security systems

KBKG GUIDE TO ROOFING - ANALYSIS

Step 1: What type of roof is it?

- Steep-Pitch Roofing or Low Pitch/Flat Roofing



KBKG GUIDE TO ROOFING - ANALYSIS

Step 2: Apply the TPRs

- Why was the roof replaced?
- How much of each layer was replaced?
- Was the replacement because the previous building structure was in a state of disrepair?
- Did the taxpayer claim a retirement loss or partial disposition deduction for any portion of the old roof?
- How much time has elapsed between the building acquisition and the roof work completed?
- What kind of roofing did you have previously and what kind was it replaced with?
- Was the new roofing related to a physical enlargement of the property? Was it part of a larger overall project?

RESTORATION EXAMPLES – ROOFS

X owns a retail store and discovers a leak in the roof

- X replaces 60% of roof decking, roof insulation, and roof membrane.
- Restoration = improvement

Y owns factory building with roof comprised of structural elements, insulation, and waterproof membrane.

- Y replaces only roof membrane with <u>comparable</u> but new membrane. (so it's not a betterment).
- Roof membrane is a minor portion of the roof system (even though it affects the function of the building)
- Not a Restoration + Not a betterment = Repair Expense

RETIREMENTS AND DISPOSITIONS (FINAL DISPOSITION REGS ISSUED AUGUST, 2014)

Current rules say you can now take a loss deduction when you remove anything from your building

Example: If you pay $50,000 for all new lighting in your building, you need to capitalize that amount over 39 years.

- Can now calculate value of old lights and take immediate deduction for any remaining basis

FINAL REGS: “Partial Dispositions Election” is needed on timely filed tax return including extensions for year portion of asset is disposed.

http://kbkg.com/solutions/partial-disposition-calculator

RETIREMENT OF STRUCTURAL COMPONENTS

Example: Taxpayer acquired $5M building in 2012

- 2021 they spent $1M to remodel portion of 2nd floor (ceilings, walls, lighting, plumbing, ducting, electrical wiring, etc.)
- "Retirement Study" determines the original cost basis of demolished components is $470K (from the original $5M building)
- Recognize a loss of **$404K** (original cost basis less depreciation already taken)

RETIREMENTS CREATE PERMANENT TAX SAVINGS!

Retirements Convert Recapture Tax into Capital Gains

- If you incorrectly continue to depreciate 1245 & 1250 property that was removed from a building, you pay recapture tax upon sale
  - 1245 recapture is at ordinary rates (37%);
  - 1250 recaptured at 25%
  - Capital Gains are typically taxed at 20%

RETIREMENTS CREATE PERMANENT TAX SAVINGS!

Previous Example: $5M building with $470K of retirements.

- If they continue to depreciate the $470K, they recapture all of it upon sale
  - Let's say $370K of that was 39 year & $100K was 7 year property
  - **Recapture Tax = $129,500**

    ($370K x 25% + $100K x 37%)

- If they do a Retirement Study
  - Recapture tax on the $470K = 0
  - **Capital gain tax = $94,000**

    ($470K x 20%)

$ Permanent tax savings of $35,500 upon sale

POLLING QUESTION #3

ROUTINE MAINTENANCE SAFE HARBOR

Expense if you reasonably expect (at time placed in service) to perform more than once during class life (alternative depreciation system)

- **Safe harbor does not apply to Betterments, Adaptations** (see Reg.§1.263(a)-3(i)(3))

FOR BUILDINGS: must reasonably expect to perform more than once during the *ten year* period from when the building system was placed in service.

- Ex. Expense - Every 5 years the escalator hand rails are replaced

KBKG Commentary: It can fail safe harbor and still be considered an expense!

- Ex. Every 12 years we replace HVAC unit. Fails Safe Harbor but can still satisfy the BAR standards.

ROUTINE MAINTENANCE SAFE HARBOR – REFRACTORY BRICK EXAMPLE

POLLING QUESTION #4

DE MINIMIS RULE EXPENSING SAFE HARBOR § 1.263(A)-1(F)

Taxpayer with an Applicable Financial Statement (AFS)

- $5,000 expensing threshold per *item* or invoice for property
- Must have written expensing policy stating such
- Must treat amounts as expenses on the AFS as well

Taxpayer without Applicable Financial Statement (AFS)

- $2,500 expense threshold per *item* or invoice
- Do not need written expensing policies

- Can not split costs among multiple invoices
- If elected, must apply to all eligible materials & supplies except, rotable, temporary, and standby emergency spare parts.

APPLICABLE FINANCIAL STATEMENTS DEFINED

Financial statement filed with Securities and Exchange Commission (SEC) (the 10-K or the Annual Statement to Shareholders);

Certified audited financial statement accompanied by report of an independent CPA that is used for:

- Credit purposes;
- Reporting to shareholders, partners, or similar persons; or
- Any other substantial non-tax purpose; or

Financials required to be provided to any federal or state agency (other than SEC or the IRS).

IRS RELEASES AUDIT TECHNIQUES GUIDE RELATED TO CAPITALIZATION OF TANGIBLE PROPERTY

KBKG Tax Insight: IRS Releases Audit Techniques Guide Related to Capitalization of Tangible Property

On September 14th, 2016, the IRS issued an Audit Techniques Guide (ATG) for the Capitalization of Tangible Property. The ATG is a tool that IRS examiners can use for identifying potential tax issues and setting up their audit plans. Tax professionals who have implemented a change in accounting method to re-characterize the treatment of tangible property should be aware of the issues within the ATG guide and how potential audits will be structured. In the ATG, the IRS stresses that "the burden of proof rests with the taxpayer, and sufficient contemporaneous records are required."

> **KBKG Insight**: This new ATG is being released as the Service prepares for a substantial number of audits related to Tangible Property Regulations. To be prepared for IRS examination, taxpayers should ensure that the proper determination has been made with respect to each unit of property (UOP) and what is considered a repair and maintenance cost.

The IRS states "with the issuance of the final regulations, the demand for cost segregation studies is on the rise." As part of the audit plan, agents have been instructed to review all current and prior cost segregation studies to ensure they were completed properly. Overall, the ATG further heightens the need for detailed cost segregation studies that can help property owners determine each UOP and each major building component that could be replaced in the future.

To read Capitalization of Tangible Property: Treas. Reg. § 1.263(a) and related regulations, visit: http://kbkg.com/docs/irs-treas-reg-1.263a.pdf

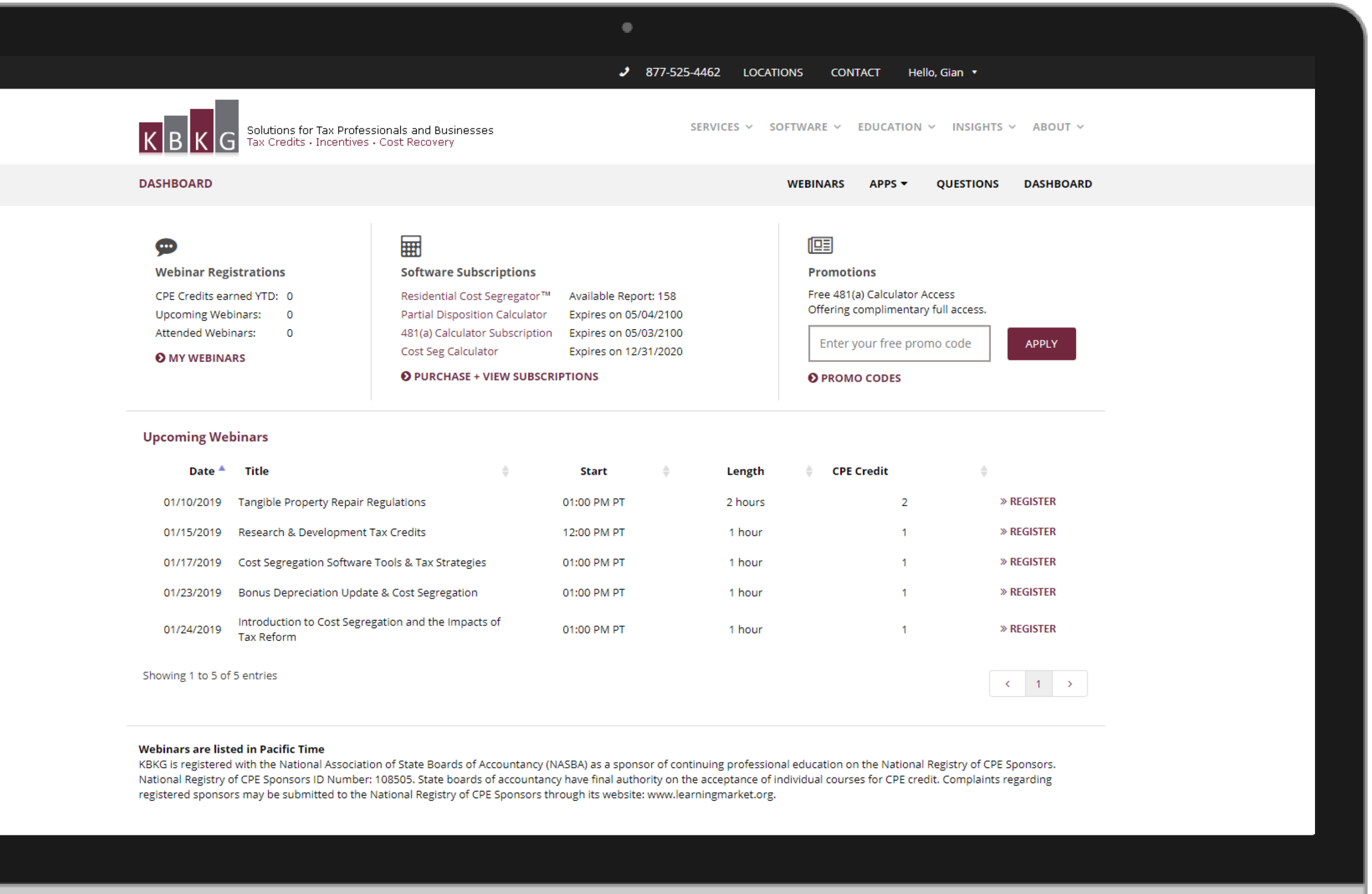
HOW KBKG CAN HELP

Comprehensive Fixed Asset Review:

- Dedicated team of experts devoted to accelerating deductions within the fixed assets register by identifying:
  - Missed cost segregation opportunities;
  - Retirements and other dispositions;
  - Individual asset reclassifications to shorter lives;
  - Capital to expense opportunities; and
  - Depreciation errors for missed deductions.
- We can file all required 3115’s or help tax preparers in this process, suggest elections, and assist with related compliance.
- KBKG has developed proprietary software to quickly identify missed repair expenses and retirements, provide documentation, and calculated missed deductions.

KBKG'S SOLUTIONS SOFTWARE

https://solutions.kbkg.com/dashboard



- Cost Segregation Savings Calculator
- Partial Disposition Calculator
- Residential Cost Segregator®
- 481(a) Adjustment Calculator

JOHN MANOLOS

Senior Manager – Cost Segregation
877.525.4462 ext. 177
john.manolos@kbkg.com

kbkg.com/management/john-manolos

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