Tax Watch

BROWNEDWARDS
certified public accountants

January 28, 2015
Issue 2

On January 17, 2015 the IRS issued additional guidance on the new Tangible Property Regulations (TPRs). Many had hoped this guidance would postpone the implementation or limit the requirement for filing change of accounting methods with your 2014 tax filings. The most recent guidance retains substantially all of the guidance of the September 2013 regulations. These regulations clarify the treatment of tangible property expenditures, whether tangible personal or real property. These new TPRs provide guidance on the capitalization and depreciation of capital expenditures, the treatment of materials and supplies, and the opportunity to write off all or a portion of an asset when disposed of. They present new risks and opportunities that affect taxpayers in every industry that owns depreciable capital assets, spends funds on repairs and maintenance, and/or material and supplies. Below is a summary of the new regulations and how they will impact your business.

Required Tax Filings

The good news of the TPRs is that taxpayers who have significant fixed assets with remaining depreciation or real property will typically have large current and future tax deductions. In order to obtain these tax deductions, a significant amount of "one time" work and related IRS tax filings need to occur, and occur for the tax year 2014. This work relates to accounting method change forms. On the other hand, taxpayers who have been able to write their asset acquisitions off under bonus or Section 179 deductions will see minimal tax deductions but are still subject to the "one time" new tax filing requirements for 2014.

It is unfortunate that the IRS has required the majority of the TPRs to be implemented: (a) retroactively, and (b) via the filings of numerous additional required special tax forms for tax year 2014. Retroactive application of the TPRs requires taxpayers to revisit every asset on its depreciation schedule to see if it should have been capitalized under the new capitalization rules or criteria (see below).

If a prior asset/expenditure does not qualify as an asset under the new principals, it must be written off by 2014, or the opportunity to write off that item during the tax year 2014 will be lost. The scary part of the TPRs is the threat of the IRS to disallow any future depreciation for prior items that do not pass the new capitalization criteria. Additionally, the IRS requires that the accounting method change forms not all be filed together. This could require several different sets of these forms to be filed.

The word "required" used above is very important to us as your tax return preparers. As CPAs and as your tax preparer, we are required to follow the rules and restrictions of our state and federal licensing parameters. Those parameters subject us to very large preparer's penalties and sanctions, should we not follow them. One of those rules and regulations prohibits us from preparing and/or

signing your 2014 return unless that return includes the new TPR implementation and form submissions.

Capital Expenditures

Taxpayers and their accountants have always faced the challenge of differentiating between what are capital improvements or repair and maintenance expenses as they sought the balance between accurately reflecting business profits verses maximizing tax deductions. The new TPRs dictate that expenditures must be written off as repairs if they are not required to be capitalized. That is, repairs and maintenance are the opposite of what is required to be capitalized. Consequently, an understanding of the capitalization rules is imperative. Rule: a taxpayer must capitalize any amounts that are paid to improve a unit of property or assets purchased. One makes an improvement to a unit of property if it is deemed to be betterment, a restoration, or adaption to a new or different use. The employment of this guidance is heavily fact specific. While there are no bright line tests, there are now known specific criteria that need to be applied to the expenditures. The new criteria also require a thorough review of the past and future expenditures on improvements. That review will determine if prior capitalized expenditures should now be written off and will determine whether future ones will be capitalized.

Unit of Property

The foundation of the capitalization rules is in the comparison of the expenditure to the unit of property. A unit of property consists of a group of functionally interdependent components. In other words, if placing one component in service is dependent on placing another component in service, then they are functionally interdependent and considered one unit of property. For example, a truck and its components (engine, tires, etc.) are one unit of property because each of those components needs to be placed in service at the same time in order for the truck to function. The regulations have special rules for buildings. In general, a building and its structural components are one unit of property. Examples of the structural components would be roofs, walls, floors, ceilings and other items that relate to the operation of a building. There are also certain "building systems" that the regulations have defined as separate units of property. These building systems include HVAC system, plumbing, electrical, escalators, elevators, fire protection, alarm/security and gas distribution. Even though a building is one unit of property, the capitalization criteria must be applied at the building structure or system level, and then even smaller comparisons for any item that performs a material and discrete function.

New Capitalization Criteria

Once a unit of property is defined, a taxpayer then needs to determine if the amounts paid result in a betterment, restoration or adaption to new/different use, as follows:

Betterment: Funds spent to correct a material defect/condition that existed prior to the acquisition of a unit of property; result in a material addition to the unit of property (i.e. enlargement, expansion or extension); and/or result in a material increase in capacity, productivity, efficiency, strength, quality or output of the unit of property.

Restoration: Funds spent to return the unit of property to its ordinarily efficient operating condition if the property was in disrepair and no longer functional; replacement of a component of a unit of property where a gain/loss is recognized on the component; rebuilding the unit of property to a like-new condition after the end of its class life; or the replacement of part(s) that comprise a major component, large physical portion, or substantial structural part of the unit of property.

New/Different Use: Funds spent to adapt a unit of property to a new or different use if the adaption is not consistent with the taxpayer's original intended use of the unit of property when acquired.

Example: *Able Contractors LLC purchased a bulldozer tractor in 2008. In 2014, it paid $20,000 to have the engine and transmission rebuilt and everything repainted. Under the new regulations, this cost would fall under the restoration category discussed above and would be required to be capitalized. The applicable class life for a contractor is 6 years and in this example the item was rebuilt to a like-new condition after the end of its class life. Let's assume the same facts but the bulldozer was purchased in 2010. As the class life of the tractor (6 years) does not end until 2015, the expenditures could be deducted.*

Routine Maintenance Safe Harbor (RMSH)

The IRS offered some opportunities in the regulations by acknowledging that taxpayers do incur expenditures that assist in keeping a unit of property in its efficient operating condition. As a result, the IRS created the RMSH rule that allows taxpayers to expense certain costs that are routine and reoccur at specific times during the use of unit of property. For personal property, an activity is reoccurring if you expect to do it more than once during the applicable class life of the unit of property. The RMSH has special rules for buildings and their structural components. In the case of a building and/or its components, an expenditure can be treated as a repair & maintenance if one reasonably expect to perform it more than once over a 10 year period of time.

De Minimis Safe Harbor (DMSH) to acquire property

When a taxpayer purchases a unit of property, generally capitalization is required; however, the IRS provided some relief under the TPRs by creating a DMSH exception. This exception allows taxpayers to immediately deduct amounts they pay to acquire or improve property, if the taxpayer complies with all of the DMSH rules. The DMSH rules can be applied by all taxpayers if the rules are met. First, one must have a capitalization policy in place before the tax year starts. This policy must specify that an expenditures under a certain dollar amount (i.e. like $1,000 and under). Additionally, the taxpayer must have an invoice, and deduct the expenditure on its books. Under the regulations, taxpayers who have an applicable financial statement (AFS) are granted safe harbor to be able deduct up to $5,000 of the cost of an item of property (per invoice) or expenditure. For those who do not have an AFS, the $5,000 safe harbor is reduced to $500 per item. Although the regulations state the $5,000/$500 as safe harbor limits, the capitalization policy should be set to an appropriate level for your business. During an IRS audit, the taxpayer has the burden of proving to the IRS that the amount paid in excess of the safe harbor was reasonable. The DMSH is a safe harbor and not a restricted ceiling limitation. Example: XYZ, Inc. does not have an AFS, has a written policy in place before tax year begins that states they will expense property that costs $500 or less. XYZ purchases 25 items that cost $400 each

on a total invoice of $10,000. Since XYZ has a written policy in place and each item (unit of property) is $500 or less, XYZ must expense the full $10,000 paid if it writes these items off on its books.

Disposals

As another positive aspect of the TPRS, it also allows taxpayers the opportunity to partially dispose of duplicate portions of property, including buildings and their structural components. Historically, for example, if one replaced a roof on a building and capitalized the replacement costs the taxpayer was not allowed to dispose of the prior roof. Under the TPRs, a taxpayer can elect to dispose of the prior roof. These partial asset dispositions provide an opportunity to write off duplicable assets for tax years prior to 2014 and are only available through the filing of the 2014 tax returns.

Materials and Supplies

Materials and supplies (M & S) are defined as tangible property, excluding inventory, which is used or consumed in operations and is: either (a) A component acquired to maintain, repair or improve a unit of tangible property, (b) bulk, such as fuel, water, lubricants and similar items that are reasonable expected to be used in 12 months or less, (c) temporary or emergency spare parts, (d) units of property whose useful life is 12 months or less, or (e) a unit of property with a cost less than $200. Once an item is determined to be M & S, the regulations require a taxpayer to classify these M & S as either incidental or nonincidental. Incidental materials and supplies can be deducted when they are purchased. On the other hand, nonincidental materials and supplies are required to be deferred and deducted in the year they are used or consumed. No later than tax year 2014, taxpayers are required to defer and keep a physical inventory or a record of consumption for its nonincidental M & S. This rule is trumped, up to the taxpayer's DMSH.
Taxpayers must review and adapt its accounting by tax year 2014 to conform its treatment of M & S to the TPRs. Example, Bob's Wood Shop has temporary machine parts and bulk wood treatment on hand at tax year end 2014, that are above its DMSH. Bob's has to defer, and not take as tax deduction in 2014, these items.

Our Approach

At Brown Edwards, we are not only concerned with proper compliance to tax law but also the cost of such compliance on our clients. In order to comply with the changes required by the Tangible Repair Regulations, we have developed a system to complete the necessary forms in the most efficient manner possible. As noted, most returns will have some form of additional filing related to the regulations. Our goal is to achieve this compliance with the least amount of disruption to your operations and lowest possible cost.

Conclusion

While the new regulations are complex, understanding how they impact your business is critical to maximizing tax deductions while maintaining tax compliance. Past decisions regarding material and supplies expenditures, as well as the capitalization or write off of repairs and maintenance must be reviewed to determine what changes are necessary under the new regulations. These changes will require the filing of certain IRS tax forms no later than tax year 2014 while other changes are either

new annual elections or choices. Your Brown Edwards advisors have the resources to assist you in determining how these new regulations will affect your business and we are committed to do so in the most cost effective manner possible.

Your Success Is Our Focus. **BrownEdwards@becpas.com**

www.becpas.com