Implementing the new tangible property regulations

The revised "repair regs." require thorough assessment.

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After nearly a decade in the making, the final tangible property regulations have arrived. These regulations will affect every taxpayer that uses tangible property in its business. The rules are all-encompassing and complex, and implementation will require careful consideration of each taxpayer’s facts and circumstances. In addition, taxpayers may need to devise new collection procedures to capture the necessary data to implement these regulations.

On top of that, Circular 230, Regulations Governing Practice Before the Internal Revenue Service (31 C.F.R. Part 10), may present challenges to practitioners in signing tax returns for clients that have not implemented the final regulations. Due to the challenges of the regulations, waiting to address these issues until completing the 2014 tax return is ill-advised. This article provides some history, context, and a high-level overview of the major components of the final regulations and discusses the implications for Circular 230 and signing tax returns for clients who have not implemented the new regulations.

A HIGHLY FACTUAL DETERMINATION

Since the inception of the Internal Revenue Code, the IRS and taxpayers have been at odds over whether expenditures on tangible property are currently deductible or must be capitalized and recovered through depreciation over time. The distinction between deductible repairs and capital improvements has been determined largely through case law and is based on facts and circumstances. The Supreme Court has held that determining whether expenditures are for capital improvements or for ordinary repairs is highly factual. Whether expenses are capital or ordinary is a matter "of degree and not of kind" (Welch, 290 U.S. 111, 114 (1933)), and each case "turns on its special facts" (Deputy v. DuPont, 308 U.S. 488, 496 (1940)).

The IRS issued the final regulations (T.D. 9636) in September. They are generally applicable to tax years beginning on or after Jan. 1, 2014, and optionally in their temporary form to tax years beginning after 2011. The prior rules can be summarized as follows: Currently deductible repair and maintenance expenses are those incurred for the purpose of keeping property in an ordinarily efficient operating condition over its probable useful life for the uses for which the property was acquired. Capital expenditures, in contrast, are for replacements, alterations, improvements, or additions that appreciably prolong the life of the property, materially increase its value, or make it adaptable to a different use.

Restated, expenditures that restore the property to its operating state are a deductible repair. However, expenditures that provide a more permanent increment in longevity, utility, or worth of the property are more likely capital. For example, if a taxpayer rebuilds a business vehicle’s engine, the IRS generally considers those expenditures to be capital. In the IRS’s view, rebuilding an engine increases the value of the vehicle (the unit of property) and prolongs its economic useful life. By comparison, the IRS views regularly scheduled maintenance repairs on a business vehicle currently deductible, as they do not materially increase the vehicle’s value or appreciably prolong its useful life.
GUIDANCE

In an effort to reduce disputes with taxpayers, the IRS issued Notice 2004-6 in late 2003 announcing that it intended to propose regulations in this area. The notice identified issues and invited public comments. In response to received comments, the IRS issued proposed regulations in 2006 but withdrew them in 2008 when it issued new proposed regulations. The IRS withdrew those proposed regulations in 2011, when it issued temporary regulations that were effective for tax years beginning on or after Jan. 1, 2012. Just before the end of 2012, the IRS amended the temporary regulations to delay the effective date to tax years beginning on or after Jan. 1, 2014. However, an electing taxpayer could apply any portion of the temporary regulations to tax years beginning on or after Jan. 1, 2012.

On Sept. 16, 2013, the IRS issued the final regulations, with an effective date for tax years beginning on or after Jan. 1, 2014. In addition to the final regulations, the IRS issued proposed regulations (REG-110732-13) regarding the disposition rules and treatment of assets in a general asset account, with the intention to finalze them by year end. Included in these regulations are rules governing the distinction between fixed assets versus materials and supplies, what costs taxpayers must capitalize on the acquisition of tangible property, whether expenditures related to the property's operation are deductible repairs or capitalizable as improvements, when to recognize dispositions, and even how to define the unit of property. One way to understand the regulations is to start with the proposition that all tangible property that is not inventory must be capitalized and depreciated unless there is an exception.

MATERIALS AND SUPPLIES

One such exception is for items that qualify as materials and supplies. Generally, an item that costs $200 or less or has an economic useful life of 12 months or less qualifies as a material or supply. If the tangible property qualifies as materials or supplies, the taxpayer receives the more favorable treatment of a current deduction when the item is used or consumed, instead of having to capitalize the cost. The regulations provide an election to substitute a taxpayer's capitalization threshold (items expensed if they are under a certain dollar amount) in certain circumstances for the $200 limit under the de minimis rules.

The de minimis election is made annually, and the threshold maximum amount depends upon whether the taxpayer has a capitalization policy in place at the beginning of the year and whether the taxpayer has an applicable financial statement (generally, an audited financial statement). If a taxpayer has an applicable financial statement, the maximum threshold is $5,000; if the taxpayer does not, the threshold cannot exceed $500. Taxpayers will need to review their policy for what constitutes materials and supplies and whether the de minimis election is advantageous. Implementation of the materials and supplies rules and de minimis elections may require additional efforts to capture the information necessary to comply with the new regulations and take additional time to implement.

ACQUISITION COSTS

The final regulations generally require taxpayers to capitalize amounts paid to acquire or produce tangible property. Amounts paid to acquire or produce tangible property include costs that facilitate the acquisition or production of tangible property, including applicable transaction costs. The final regulations include special rules for costs of acquiring real property and optional elections to capitalize deductible costs or exclude certain administrative costs from capitalization. Taxpayers need to confirm that they are adequately capturing all acquisition costs under the final regulations.

UNIT OF PROPERTY

The rules for capitalizing tangible and real property begin by defining a unit of property (how the final regulations establish a single asset for capitalization purposes). Once the taxpayer establishes the unit of property, the taxpayer then applies the improvement standards under the regulations to the unit of property to see if the expenditure improves the property and requires capitalization. In general, a unit of property includes all components that are “functionally interdependent” (i.e., the placing in service of one component depends upon the placing in service of another component). For example, a taxpayer generally cannot place an automobile into service without tires; therefore, the automobile and tires may be a unit of property.

An additional rule provides that if the taxpayer breaks down the unit of property into smaller components with different depreciation lives, then the smaller components are the units of property. For example, if the taxpayer treats a vehicle’s tires under a different modified accelerated cost recovery system (MACRS) class than the vehicle, the tires are a separate unit of property from the vehicle. There are also special rules for buildings and plant equipment, as well as published guidance issued under the industry issue resolution process for specialized industries.

**IMPROVEMENTS**

Under the final regulations, an expenditure must be capitalized if it results in a betterment to the unit of property, adapts the unit of property to a new or different use, or results in a restoration of the unit of property (referred to as the BAR tests). Generally, an expenditure results in a betterment if it ameliorates a condition or defect that existed before the acquisition of the property or arose during the production of the property; is for a material addition to the property; or increases the property’s productivity, efficiency, strength, etc. An expenditure results in an adaptation to a new or different use if it adapts the unit of property to a use inconsistent with the taxpayer’s intended ordinary use at the time the taxpayer originally placed the property into service. An expenditure results in a restoration of an asset if the expenditure (1) restores basis that has been taken into account (e.g., as a loss or in computing gain or loss); (2) returns the unit of property to working order from a state of nonfunctional disrepair; (3) results in a rebuilding of the unit of property to a like-new condition after the end of the property’s alternative depreciation system class life; or (4) replaces a major component or substantial structural part of the unit of property.

It is important to note that the expenditure is tested against all the BAR tests. Even if an expenditure does not constitute a betterment, the taxpayer may still have to capitalize it as an adaptation to a new use or as a restoration. Expenditures on existing assets that do not meet the BAR tests are generally deductible repairs.

**DEEMED DISPOSITIONS**

The final regulations expand the rules regarding dispositions of MACRS assets. Taxpayers now must recognize a gain or loss when assets are permanently withdrawn either from use in the taxpayer’s business or from the production of income. A disposition includes the sale, exchange, retirement, physical abandonment, or destruction of an asset or when an asset is transferred to a supplies, scrap, or similar account. It also includes the retirement of a structural component of a building.

If the taxpayer disposes of the asset by sale, exchange, or involuntary conversion, the taxpayer must recognize gain or loss. If the asset is abandoned, the taxpayer must recognize loss in the amount of the asset’s adjusted depreciable basis at the time of the abandonment. However, if the abandoned asset is subject to nonrecourse indebtedness, the temporary regulations clarify that the asset is treated in the same manner as an asset disposed of by sale. If an asset is disposed of by conversion to personal use, no gain or loss is recognized.

If the taxpayer disposes of the asset other than by sale, exchange, involuntary conversion, physical abandonment, or conversion to personal use (e.g., if the asset is transferred to a supplies or scrap account), then gain is not recognized. The taxpayer must recognize loss in the amount of the excess of the asset’s adjusted depreciable basis at the time of the disposition over the asset’s fair market value (FMV) at the time of the disposition.

**SPECIAL ISSUES WITH BUILDINGS**

While a building is generally a unit of property, there are variations depending on the use of the building. For instance, if the building is a condominium complex, the unit of property is the individual unit owned by the taxpayer and the structural components that are part of the condominium unit. A similar rule for leased buildings defines the unit of property as each building and its structural components or the portion of each building subject to the lease and the structural components associated with the leased portion.

The final regulations follow the temporary regulations and require that a taxpayer apply the improvement standards separately to the primary components of the building or to any of the specifically enumerated building systems. The primary components of a building generally include walls, partitions, floors, and ceilings, as well as any permanent coverings (paneling or tiling), windows, and doors. The specifically enumerated building systems
include (1) heating, ventilation, and air conditioning systems; (2) plumbing systems; (3) electrical systems; (4) all escalators; (5) all elevators; (6) fire protection and alarm systems; (7) security systems; (8) gas distribution systems; and (9) any other systems identified in published guidance.

Under the temporary regulations, dispositions of a structural component of a building (e.g., a window) were mandatory, which created pitfalls for taxpayers who had not elected the general asset account classification for the structural components of a building. The new proposed regulations remedy this situation by treating the building and its structural components as the asset for disposition purposes, thereby eliminating the mandatory disposition rules for structural components. The proposed regulations also expand the ability to recognize disposition of partial assets at the taxpayer’s option. For example, taxpayers can now elect to recognize a loss on a replaced roof on a building. With this change under the proposed regulations, a general asset account election is no longer necessary to forgo a loss on a structural component of a building, and therefore the new proposed regulations greatly limit elective dispositions from general asset accounts.

SAFE HARBORS

The final regulations provide an elective safe harbor for routine maintenance. Under this safe harbor, taxpayers may be able to deduct expenditures for activities that the taxpayer reasonably expects to occur more than once during the class life of the asset and that do not result in a betterment. For example, if a taxpayer expects to simply resurface a parking lot (15-year property) every five years, then under the safe harbor, this expenditure is not an improvement, and the taxpayer may be able to deduct it currently. The new regulations expand this safe harbor to buildings as long as the activity occurs more than once during the 10-year period beginning at the time the taxpayer places the building in service.

Included in the final regulations is an optional method for rotable and temporary spare parts that generally permits a taxpayer to deduct the costs of a part in the tax year that the taxpayer installs the part. In the year a part is removed, the part’s FMV is included in the taxpayer’s income. This amount becomes the basis in the replaced part, increased for any costs to remove the part and any costs to put the part back into serviceable form. In the year the part is reinstalled, the taxpayer deducts the basis of the part (to the extent it has not been previously deducted) and the cost to reinstall it. When the part is disposed of, the taxpayer deducts the basis of the part to the extent it was not previously deducted.

Also included in the new regulations is a safe harbor for qualifying small taxpayers to expense expenditures related to certain real property if the expenditures do not exceed a certain threshold. Generally, that threshold is the lower of 2% of the unadjusted basis of the building or $10,000 for buildings with a basis of $1 million or less.

HOW TO IMPLEMENT THE RULES

While certain safe harbors and elections are implemented through filing statements or treatment of an item on a timely filed federal tax return, the IRS considers the remaining provisions to be accounting methods. A taxpayer seeking to change to a method of accounting permitted in the final regulations must secure the IRS’s consent before implementing that new method. Under the temporary regulations, the IRS granted consent through the automatic consent procedures in Rev. Proc. 2011-14. The IRS indicated it will follow the same procedures and publish accompanying revenue procedures allowing taxpayers to use Rev. Proc. 2011-14 to obtain consent to change their accounting methods to comply with the final regulations. Under the automatic consent procedures, the IRS will grant consent when the taxpayer accurately completes a Form 3115, Application for Change in Accounting Method, attaches the form to the taxpayer’s timely filed tax return for the year of change (with extensions), and submits a signed copy to the IRS’s national office.

With the new regulations effective for tax years beginning on or after Jan. 1, 2014, almost every federal tax return for businesses that own tangible property should have at least one Form 3115 or an election statement that the taxpayers will need to file to adopt the rules under the final regulations. For example, taxpayers will need to file a Form 3115 to adopt the materials-and-supplies provision or file an election statement to use the de minimis rules. Failure to include the Form 3115 or election statement may indicate either an unauthorized accounting method change (one that did not obtain the IRS’s required consent) or the taxpayer’s noncompliance with the final regulations.

CIRCULAR 230 IMPLICATIONS
Circular 230 governs practice before the IRS (including by CPAs and other enrolled tax return preparers), which includes preparing documents, filing documents, and communicating with the IRS. Under Section 10.34 of Circular 230 a practitioner may not willfully, recklessly, or through gross incompetence sign a tax return or claim for refund that the practitioner knows or reasonably should know contains a position that lacks a reasonable basis. Failure to comply with Circular 230 could result in censure, suspension, or disbarment of any practitioner from practice before the IRS.

There is also no materiality threshold for Circular 230, which means that if a CPA files a federal tax return for 2014 for a client without a Form 3115 or certain election statements, the CPA could be in violation of Circular 230 and subject to disciplinary action. With the threat of possible sanctions, the complexity of the regulations, possible new recordkeeping requirements, and the need for certain election statements, CPAs need to have timely discussions with their clients to address the impact of the final regulations in filing clients’ 2014 tax returns.

A THOROUGH ASSESSMENT

Clearly, the new repair regulations pose considerable compliance risks both for CPAs and the businesses they advise. While they bring helpful clarity and order to the treatment of tangible property, a business client’s tax accounting in this area may have become entrenched in its own practices and methods that are no longer advisable or even in some cases defensible. By the same token, through new safe harbors and other taxpayer-favorable features, the regulations may provide tax planning opportunities for some businesses that have yet to fully appreciate or implement them. In either case, CPAs’ expeditious and thorough assessment of business clients’ current and planned treatment of tangible property acquisitions, improvements, repairs, and dispositions can go a long way toward making this transition painless and even advantageous for them.

EXECUTIVE SUMMARY

General principles of capitalization versus expensing of tangible property used in a trade or business have long depended on facts and circumstances to determine whether expenditures maintain or restore property in or to its ordinarily efficient operating condition (expense) or appreciably prolong its life, materially increase its value, or adapt it to a different use (capitalization).

With temporary and now final regulations, the IRS has provided rules for classifying property as deductible materials and supplies and provided guidelines for identifying (generally capitalized) costs of acquiring tangible property. A key area addresses what is a unit of property versus a component, with implications for determining depreciation class life.

A capitalizable improvement to property is also now more precisely defined, mainly as expenditures that result in a betterment, adapt the property to a new or different use, or restore it to working order or like-new condition after the end of its depreciation class life (the BAR tests).

Because many businesses will need to elect new treatment for 2014 that may require an application for an accounting method change, CPAs should be vigilant over any resulting taxpayer compliance risk and their own responsibilities under Circular 230.

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