Tangible Property Regulations

What you need to know

New Filing Requirements for Tax Year 2014

In September of 2013, the IRS issued regulations required to be employed on 2014 tax year returns that created guidelines for treatment of tangible property expenditures, whether personal or real property. These new tangible property regulations (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. They present new risks and opportunities that affect taxpayers in every industry that either own depreciable capital assets, spend funds on repairs and maintenance, and/or material and supplies.

Required Tax Filings

Taxpayers who have significant fixed assets with remaining depreciable basis 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 prior to filing your 2014 return.

On the other hand, taxpayers who have been able to write off their asset acquisitions under bonus depreciation 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
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 their depreciation schedule to see if it should have been capitalized under the new capitalization rules. If a prior asset/expenditure does not qualify as an asset under the new principals, it must be written off in 2014, or the opportunity to write off that item with the filing of your 2014 return 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.

The word "required" used above is very important to us as your tax return preparers. As CPAs and 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 penalties and sanctions, should we not follow them.

EXAMPLE: *ABC, Inc. capitalized a $40,000 parking lot expenditure ten years ago. After applying the new criteria, it is determined that the remaining tax depreciation of $30,000 should be written off in 2014. If ABC does not properly complete the "one time" tax filings in their 2014 return, ABC will permanently lose $30,000 as a tax deduction. It is not allowed to continue to take annual depreciation for this item. ABC has to file those numerous "one time" tax forms. Additionally, the IRS requires that the accounting method change forms not all be filed on one form. This will require several filings.*

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 have always faced the challenge of differentiating between capital improvements or repair and maintenance (R & M) expenses as they sought the balance between accurately reflecting business profits versus 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.

The employment of this guidance is heavily fact specific. While there are no bright line tests, there is now specific criteria that needs to be applied to the expenditures. The new criteria also requires a thorough review of past and future expenditures on improvements. That review will determine whether prior capitalized expenditures should now be written off and will determine whether future ones will be capitalized.

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 a betterment, restoration, or adaption to a new or different use.

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Unit of Property (U of P)

The foundation of the capitalization rules is in the comparison of the expenditure to the Unit of Property (U of P). A U of P 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 U of P.

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 U of P. Examples of 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, plumbing, electrical, escalators, elevators, fire protection, alarm/security and gas distribution. Even though a building is one U of P, 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 U of P is defined, a taxpayer then needs to determine if the amounts paid result in a betterment, restoration or adaption to a new or different use, as follows:

- Betterment: Funds spent to correct a material defect/condition that existed prior to the acquisition of a U of P; result in a material addition to the U of P; and/or result in a material increase in capacity, productivity, efficiency, strength, quality or output of the U of P.
- Restoration: Funds spent to return the U of P to its ordinarily efficient operating condition if the property was in disrepair and no longer functional; replacement of a component of a U of P where a gain/loss is recognized on the component; rebuilding the U of P 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 U of P.
- New/different Use: Funds spent to adapt a U of P to a new or different use if the adaption is not consistent with the taxpayer's original intended use of the U of P when acquired.

EXAMPLE: *A contractor purchased a bulldozer tractor in 2008. In 2014, it paid $20,000 to have the engine and transmission rebuilt and 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. If purchased in 2010, 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 U of P 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 the U of P. For personal property, an activity is reoccurring if you expect to do it more than once during the applicable class life of the U of P. The RMSH has special rules for buildings and their structural components.

In the case of a building and/or its components, the expenditure can be treated as a repair if one reasonably expects 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 U of P, 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 these rules are met:

- A capitalization policy is in place before the tax year starts. This policy must specify that an expenditure is under a certain dollar amount.
- The taxpayer must have an invoice and deduct the expenditure on its books.

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Under the regulations, taxpayers who have an applicable financial statement (AFS) are granted safe harbor to be able to 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 set the $5,000/$500 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.

Partial Asset Disposition (PAD)

Taxpayers have the opportunity to 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. For one time only in 2014, taxpayers are allowed to write off duplicate assets for tax years prior to 2014 – available only through the filing of the 2014 tax forms. This could be a significant benefit that you do not want to miss.

EXAMPLE: *A building owner built a building in 2002. In 2010, the owner capitalized costs incurred for a new HVAC. After applying the new capitalization criteria tests, it was determined that the owner properly capitalized the costs of the HVAC. The owner now has two HVACs. With this limited opportunity, the owner can, in 2014, deduct the net book value of the initial HVAC.*

Materials & Supplies

Materials and supplies (M&S) are defined as tangible property, excluding inventory, which is used or consumed in operations and is either:

a) components acquired to maintain, repair or improve a unit of tangible property,
b) bulk, such as fuel, water, lubricants and similar items that are reasonably 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 U of P with a cost less than $200.

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 these items and not take as a tax deduction in 2014.*

Once an item is determined to be M & S, the regulations require a taxpayer to classify these 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. Taxpayers are required to defer and keep a physical inventory or a record of consumption for its nonincidental M & S no later than tax year 2014. This rule is trumped, up to the taxpayer's DMSH. Taxpayers must review and adapt their accounting by tax year 2014 to conform their treatment of M & S to the TPRs.

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 the M & S expenditures, as well as the capitalization or write off of R & M 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.

Contact Us Today.

For more details about how the filing requirements related to the new Tangible Property Regulations impact you, please contact your TLD advisor:

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