



AN ALERT FROM SMITH LEONARD PLLC:

Smith Leonard Tax Update



 **Subject**

FINAL SECTION 263(a) TANGIBLE PROPERTY “REPAIR” REGULATIONS: OVERVIEW AND ACTION ITEMS

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FINAL SECTION 263(a) TANGIBLE PROPERTY “REPAIR” REGULATIONS: OVERVIEW AND ACTION ITEMS

SUMMARY

On September 13, 2013, the Department of the Treasury and the Internal Revenue Service filed with the Federal Register the final tangible property regulations (T.D. 9636). The final regulations provide guidance for taxpayers in determining whether a taxpayer must capitalize costs incurred in acquiring, maintaining, or improving tangible property under sections 162(a) and 263(a).

The Service has also separately issued proposed regulations on the disposition of tangible depreciable property, including rules for general asset accounts (“Proposed Disposition Regulations”).

The new rules affect all businesses that acquire, produce, or improve property. The final regulations adopt a significant portion of the temporary regulations issued in December, 2011, while also expanding and clarifying certain aspects of those regulations.

The regulations could result in tax savings under some accounting methods and exposure in other areas, all depending on each company’s unique facts and circumstances.

EFFECTIVE DATES

The final regulations are generally effective for taxable years beginning on or after January 1, 2014. Early adoption is allowed for taxable years beginning on or after January 1, 2012, with certain limitations.

DE MINIMIS SAFE HARBOR

The de minimis rule under the temporary regulations was revised in several important ways. The temporary regulations imposed a “ceiling” on the total amount of de minimis expenses a taxpayer was permitted to deduct annually. This de minimis ceiling was an administrative burden for many taxpayers and was among the provisions in the temporary regulations



receiving the most comments. In the final regulations, the ceiling was removed, replacing it with a new safe harbor.

The de minimis safe harbor allows taxpayers to set a minimum capitalization threshold. The policy must be in writing as of the beginning of the taxable year, as early as January 1, 2014, for calendar-year taxpayers. The policy must specify that amounts will be expensed for non-tax purposes if the amounts are below a specified dollar amount or if the amounts paid are for property with an economic useful life of 12 months or less. This policy must be followed on the taxpayer's applicable financial statement ("AFS"), generally a financial statement filed with the Securities and Exchange Commission or a certified audited financial statement. The temporary regulations also requested comments on the application of the de minimis safe harbor to consolidated groups. The final regulations provide that if a taxpayer's financial results are reported on the AFS of a group and the group follows a written de minimis safe harbor on its AFS, then the AFS and de minimis safe harbor of the group satisfy those requirements for the taxpayer that is a member of the group.

Taxpayers with an AFS that meet these criteria can deduct for tax purposes de minimis safe harbor amounts paid for property not to exceed \$5,000 per invoice or item as substantiated by the invoice.

Taxpayers without an AFS may also qualify for the de minimis safe harbor; however, the threshold amount is reduced to \$500 per invoice or item.

The Service also included anti-abuse rules to prevent taxpayers from manipulating transactions to avoid the application of the de minimis limitations at the invoice level.

The de minimis safe harbor requires an annual election statement attached to the taxpayer's timely-filed original federal tax return.

Action Item: Put an accounting policy/procedure in writing and follow it for AFS purposes by January 1, 2014. Consider electing the de minimis safe harbor annually by attaching a statement to a timely-filed original federal tax return.



MATERIALS AND SUPPLIES

The final rules for the treatment of costs of materials and supplies (“M&S”) generally follow the temporary regulations with a few key changes. The definition of M&S was expanded, increasing the \$100 limit to \$200, introducing a definition for emergency spare parts, and now limiting the election to capitalize and depreciate M&S to rotatable, temporary, and emergency spare parts. Most significantly, if taxpayers make the de minimis safe harbor election, all materials and supplies must be treated as de minimis expenses, except where the taxpayer elects to capitalize and depreciate rotatable, temporary, and emergency spare parts or follow the optional method.

Action Item: Evaluate the timing of deductions of M&S under existing accounting methods relative to the timing of deductions under the de minimis safe harbor, where elected. Consider capitalizing and depreciating M&S or using the optional method where applicable.

AMOUNTS PAID TO IMPROVE PROPERTY

The final regulations generally retain the rules of the temporary regulations for identifying the unit of property and for determining whether an expenditure is a capital improvement under the “betterment,” “adaptation,” or “restoration” standards. However, the final regulations provide additional clarifying examples, address when removal costs must be capitalized, introduce a safe harbor for small taxpayers, and expand the routine maintenance safe harbor to include buildings.

The final regulations also introduce an option to capitalize repair and maintenance expenditures if the taxpayer also capitalizes those amounts for its books and records. The election is made by attaching an annual election statement to a timely-filed original federal tax return.

Safe Harbor for Small Taxpayers

Taxpayers whose average annual gross receipts for the prior three years do not exceed \$10 million may elect not to apply the improvement rules to an eligible building property when the amount paid for repairs, maintenance, and improvements does not exceed the lesser of \$10,000 or two percent of the unadjusted basis of the building. This safe harbor is limited to buildings with an unadjusted basis not exceeding \$1 million.



The safe harbor for small taxpayers requires an annual election statement attached to the taxpayer's timely-filed original federal tax return. This safe harbor election is made on a building-by-building basis.

Action Item: Evaluate whether the administration of this safe harbor is less burdensome than applying the general improvement standards, and decide whether to elect the safe harbor for small taxpayers.

Routine Maintenance Safe Harbor for Buildings

The routine maintenance safe harbor was expanded to include building property. Amounts can generally be deducted under this safe harbor if they are incurred 1) for recurring activities a taxpayer expects to perform more than once in a ten-year period at the time the property is placed in service, 2) as a result of the taxpayer's use of the property, and 3) to keep the property in its ordinarily efficient operating condition.

Action Item: Examine current building maintenance practices and accounting policies for opportunities to deduct qualifying amounts under the safe harbor.

PROPOSED DISPOSITION REGULATIONS

The temporary regulations issued in 2011 remain in effect for taxable years beginning on or after January 1, 2012, and taxpayers thus may continue to apply those regulations until the Proposed Disposition Regulations are finalized and become effective. The proposed regulations include many of the provisions of the temporary regulations while also introducing a number of changes. The Service intends to finalize these regulations in 2013.

Under the 2011 temporary regulations, many taxpayers were concerned by a potential loss of deductions in situations where property was disposed of and the mandatory gain or loss was not recognized. This situation was mitigated under the 2011 temporary regulations by making a "general asset account" election. The Proposed Disposition Regulations introduce the same flexibility to recognize (or not recognize) a gain or loss on the partial disposition of an asset whether or not the general asset account election is made. Taxpayers can elect to claim a partial disposition and recognize a gain or loss on a disposition of a portion of an asset without making a general asset account election for taxable years beginning on or after January 1, 2014.



Taxpayers may adopt the provisions of the proposed regulations for 2012 and 2013 taxable years.

Action Item: Review accounting policies/procedures for partial dispositions of assets, including buildings, and consider revisions to recognize the gain or loss on partial dispositions. Elect to recognize gains and losses on partial dispositions on a timely-filed original federal tax return.

What Should Taxpayers Be Doing?

- Evaluate above Action Items for necessary compliance with the final regulations
- Prepare to make changes, as necessary, to book/tax accounting policies, procedures, and systems to implement compliance with these regulations
- Discuss implications with financial statement auditors to determine their expectations with regard to disclosures and accounting for uncertain tax positions
- Review cash flow needs to evaluate early adoption of beneficial provisions
- Review accounting method changes implemented prior to the issuance of the final regulations and consider filing corrective accounting method changes where necessary
- Anticipate guidance under one or more IRS revenue procedures on implementing accounting method changes and the finalization of the Proposed Disposition Regulations