



PERKINS & CO

Let's get there

Tangible Property Regulations Overview

Trent Baeckl, CPA
Tax Senior Manager

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Presentation Overview



- How did we get here?
- What areas have changed?
- What should I focus on?
- What are my must dos before year end?

Legislative Background



- 08/18/06 – Proposed Regs. Issued
- 03/07/08 – Re-proposed Regs. Issued
- 12/23/11 – Temporary & Proposed Regs. Issued
- 11/20/12 – Notice Extended Effective Date to 1/1/14
- 09/13/13 – Final “Repair” Regs. Issued under 263(a)
& Proposed “Disposition” Regs. Issued
under 162(a)
- Before 12/31/13 – Final “Disposition” Regs &
Guidance on Accounting Method
Changes Expected

Transition Rules



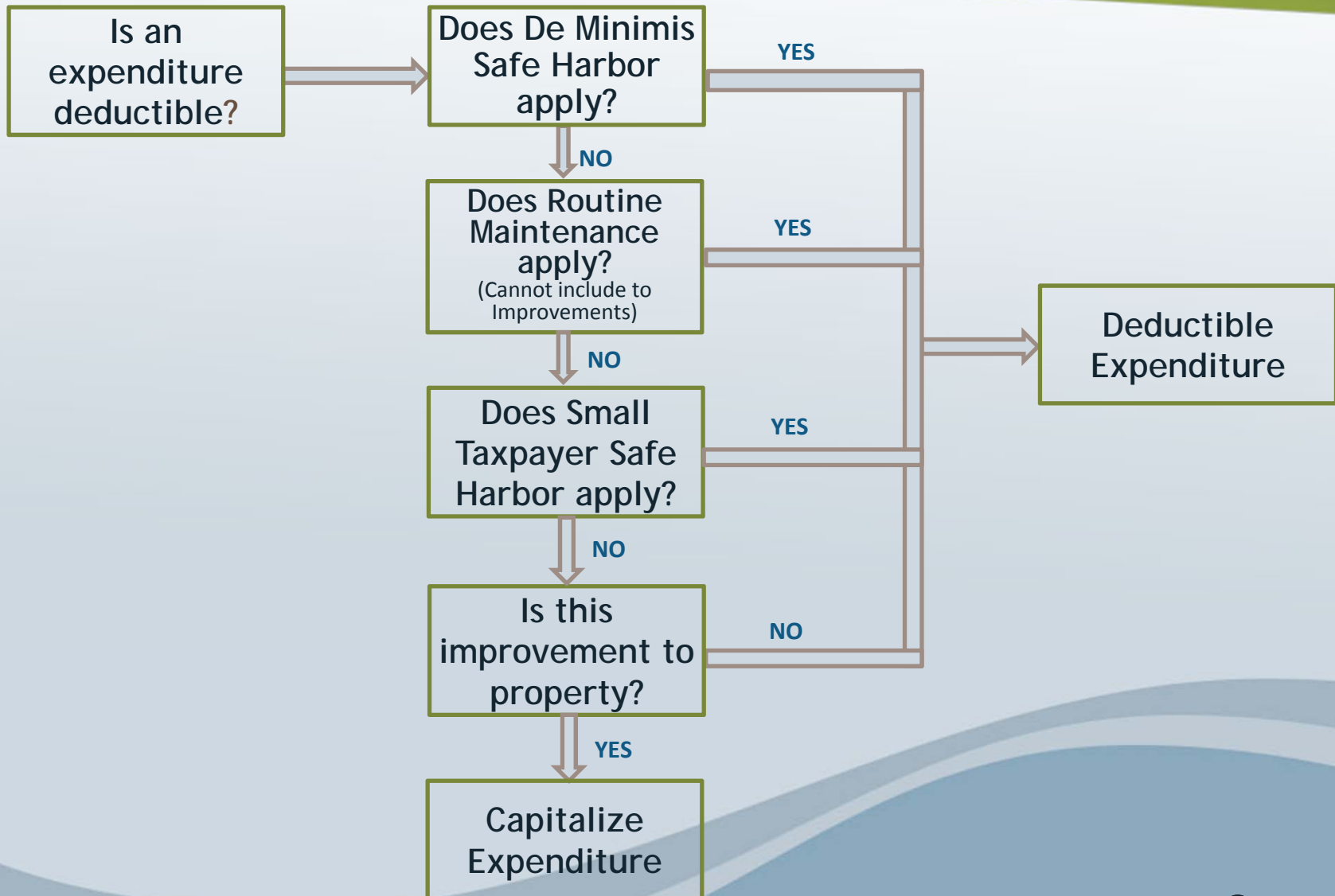
- Revenue Procedures with accounting method transition guidance expected to be released before year end, likely December, 2013
- Anticipate simplified procedures for change of accounting methods
- Mandatory application of final regulations in 2014
- Transition years 2012 and 2013:
 - Option to adopt to apply final regulations retroactively to 2012 and/or 2013
 - Apply temporary regulations to 2012 and/or 2013
 - Apply existing law to 2012 and 2013

Major Areas Covered



- Materials & supplies (M&S)
- Amounts paid for acquisition or production of tangible property
- Repairs & maintenance (R&M)
- Capital expenditures (Unit of Property, or UOP)
- Amounts paid for improvements to tangible property (BAR standards)

Determining Deductibility Overview



M&S - Definition



- Tangible property used or consumed in normal business operations that is not inventory and:
 - Is a component acquired to maintain, repair, or improve a UOP owned or leased
 - Consists of fuel, lubricants, water and similar items expected to be consumed in 12 months or less
 - Is a UOP with an economic useful life of 12 months or less, beginning when UOP is used or consumed
 - Is a UOP with an acquisition cost of \$200 or less
 - Is identified in published guidance as M&S

M&S - Treatment



➤ General Rule

- Incidental M&S deductible when purchased
- Non-incidental M&S deductible when used or consumed

➤ New Provisions

- Deduct any M&S in year purchased if safe harbor election is made
- Election to capitalize and depreciate M&S only for rotatable, temporary or emergency spare parts

Acquisition/Production of Property



› Must capitalize:

- Inherently facilitative costs
- Incurred prior to in-service date
- Defend or perfect title to property
- Required under 263A (unicap rules)

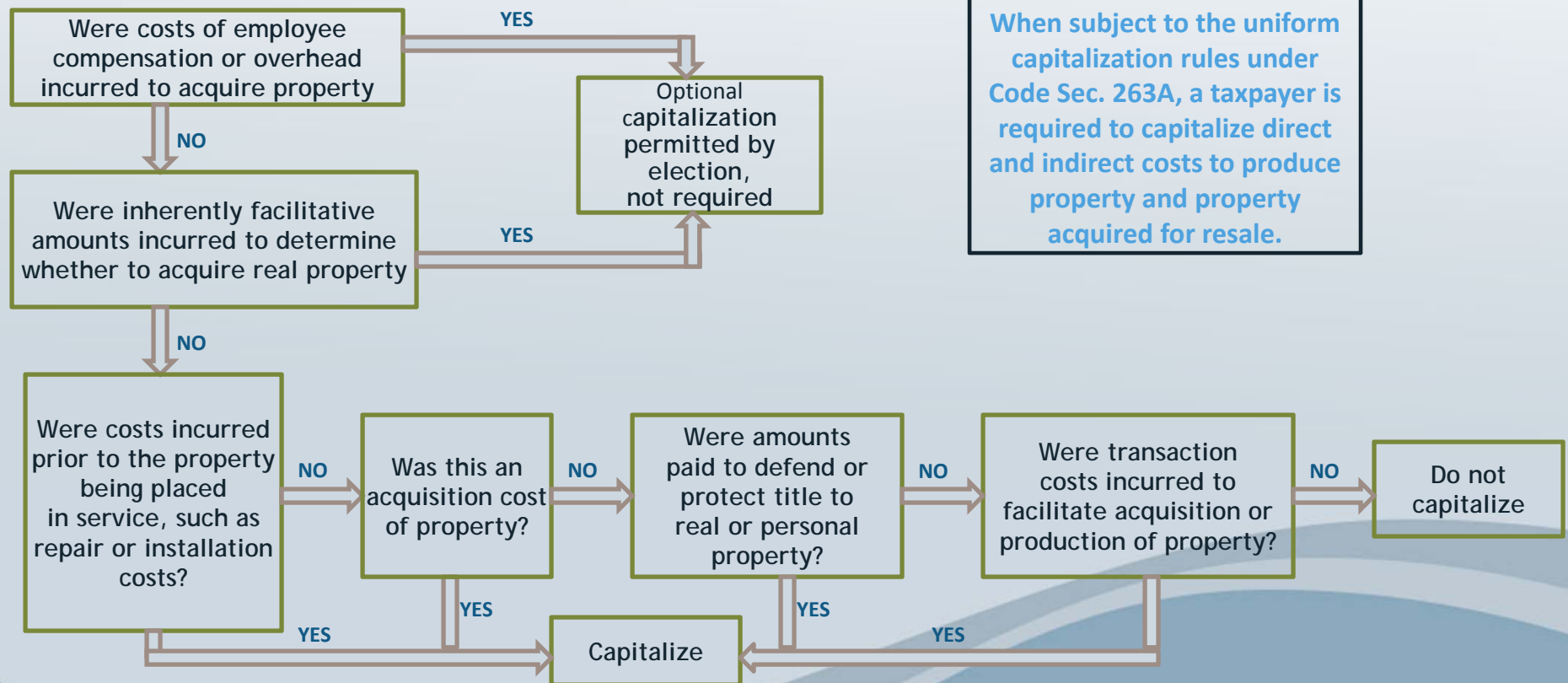
› Can expense:

- Internal labor and overhead costs
- Investigatory costs (“whether and which” for real property only)

Acquisition or Production of Property



- › A taxpayer must capitalize costs incurred to acquire or produce a unit of real or personal property.



De Minimis Expensing Rule



➤ Safe Harbor

- \$5,000 with AFS; \$500 without AFS
 - Transaction & additional costs
- \$200 for non-incident M&S
- Written policy requirement
- Annual election

UOP – Other Property



- **General Rule – Functional Interdependence**
 - A single UOP when the placing in service of one component is dependent on another component
- **Plant Property**
 - UOP is divided into smaller units comprised of each component that performs a discrete and major function or operation within the functionally interdependent machinery/equipment
- **Network Assets**
 - UOP is determined by facts and circumstances or as provided by published guidance

Unit of Property – Other Property



Functionally Interdependent:

Comprises a single unit of property when the placing in service of one component by the taxpayer is dependent on the placing in service of the other component by the taxpayer.

Plant Property:

Unit of Property as determined is further divided into smaller units comprised of each component that performs a discrete and major function or operation within the functionally interdependent machinery or equipment.

Network Assets:

Railroad track
Oil and gas pipelines
Water and sewage pipelines
Power transmission
Distribution lines
Telephone and cable lines
Unit of Property is determined by the taxpayer's particular facts and circumstances except as provided in published guidance.

UOP – Buildings



- **Nine Building System Components**
 - Building Structure (Shell)
 - HVAC
 - Plumbing
 - Gas Distribution
 - Electrical
 - Elevators
 - Escalators
 - Fire Protection
 - Security Systems

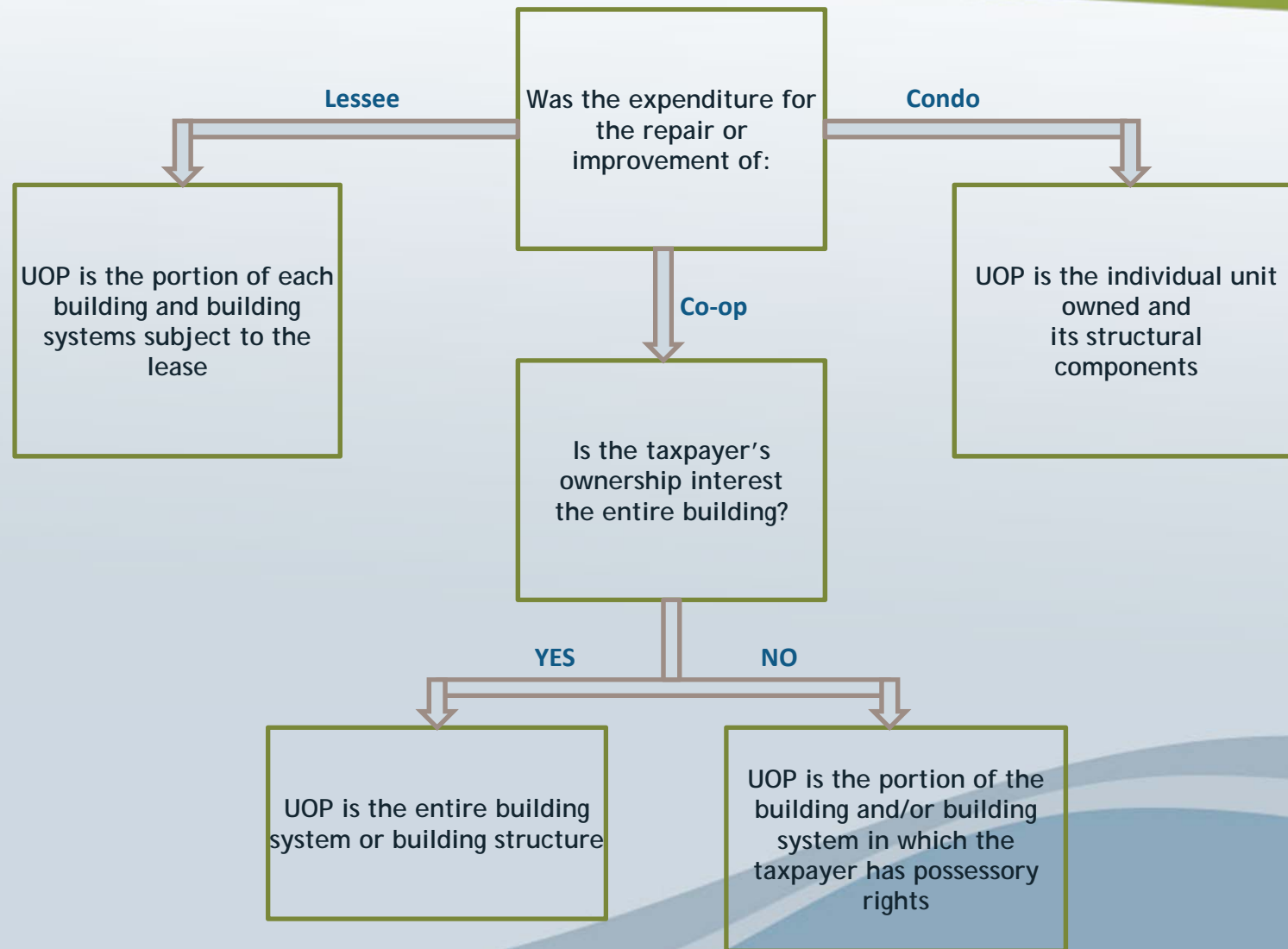
UOP – Buildings



Building Unit(s) of Property and Common Components

Building Structure	HVAC	Plumbing	Gas Distribution	Electrical	Elevators	Escalators	Fire Protection	Security Systems
<ul style="list-style-type: none"> • Roof • Walls • Floors • Ceilings • Foundation 	<ul style="list-style-type: none"> • Motors • Compressors • Boilers • Furnace • Chillers • Pipes • Ducts • Radiators 	<ul style="list-style-type: none"> • Pipes • Drains • Valves • Sinks • Bathtubs • Toilets • Water & Sewer Collection Equipment • Water Utility Equipment 	<ul style="list-style-type: none"> • Pipes • Gas Utility Equipment 	<ul style="list-style-type: none"> • Wiring Outlets • Junctions • Lighting Fixtures & Connector • Electrical Utility Equipment 	<ul style="list-style-type: none"> • Elevator Boxes • Control Equipment • Cables & Movement Equipment 	<ul style="list-style-type: none"> • Rails • Steps • Supporting Equipment • Controls 	<ul style="list-style-type: none"> • Sensing & Detection Devices • Computer Controls • Sprinkler Heads & Mains • Piping & Plumbing • Alarms • Control Panels • Signage 	<ul style="list-style-type: none"> • Window & Door Locks • Security Cameras • Recorders • Monitors • Motion Detectors • Security Lighting • Alarms • Entry Access

UOP – Leased or Condo Property



UOP Examples – Real Property



Real Property	Expenditure	UOP
Retail Store – Stand-alone	Store Refresh – Lighting replacement	Electrical system
Retail store - Shopping Mall (leased space)	Store Refresh – Lighting replacement	Leased portion of building electrical system
Office – owned building	Remove conference room wall	Building structure
Office – leased space	Remove conference room wall	Building structure within leased space
Office condo	HVAC Unit Replacement	Leased portion of building HVAC system
Apartment Building	Single Unit Heat/Air replacement	Building HVAC System

UOP Examples – Other Property



Personal Property: Non-Building	Expenditure	UOP
Restaurant oven	Burner replacement	Oven
Garbage truck	Engine repair / replacement	Truck
Apartment unit furnishings	New carpet for individual unit	Carpet
Donut bakery manufacturing line – interconnected mixers, ovens, conveyers, loaf slicer, packaging	Knife replacement / sharpening	Slicer component
Retail Donut Store Bakery – interconnected mixers, ovens, conveyers, loaf slicer, packaging	Knife replacement/sharpening	Entire baking line
Power Plant – Coal pulverizers, boilers, turbine, and a generator	Boiler tube replacement	Boiler – Refer to Industry Guidance Rev. Proc. 2013-24

Repairs & Maintenance

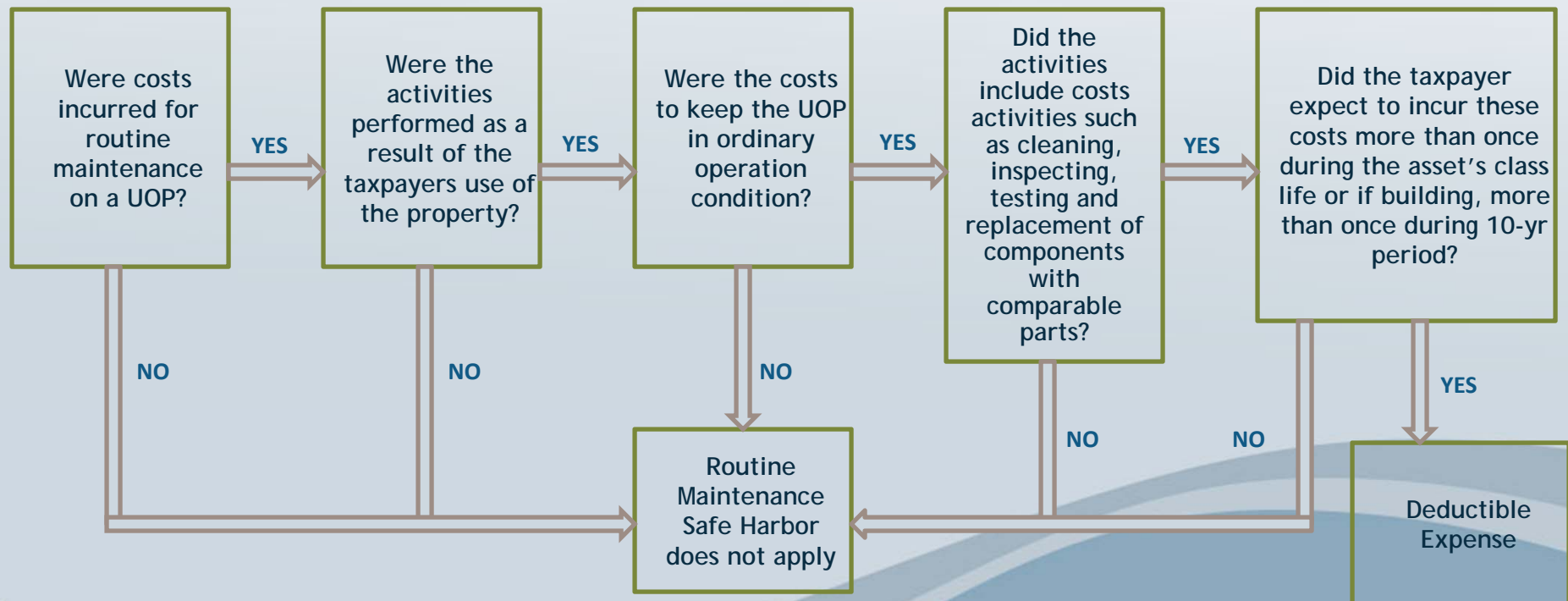


- Expense allowed for recurring activities expected to be performed as a result of use to keep UOP in ordinary efficient operating condition
- Safe Harbor for Routine Maintenance
 - Expected more than once over ADS class life
 - 10 years for buildings
 - Small taxpayer safe harbor for buildings
 - Building by building test
 - N/A for network assets

Routine Maintenance Safe Harbor



- › Taxpayers are permitted to deduct costs as routine maintenance under this safe harbor if the following tests are met:



Routine Maintenance and Safe Harbor



- › Investor purchases a shopping mall in 20X2
- › When the shopping mall was placed in service, Investor expected replace escalator handrails every 4 years.

Escalator handrails
replaced in year 4



The cost is DEDUCTIBLE
under the routine
maintenance safe harbor

Repairs & Maintenance

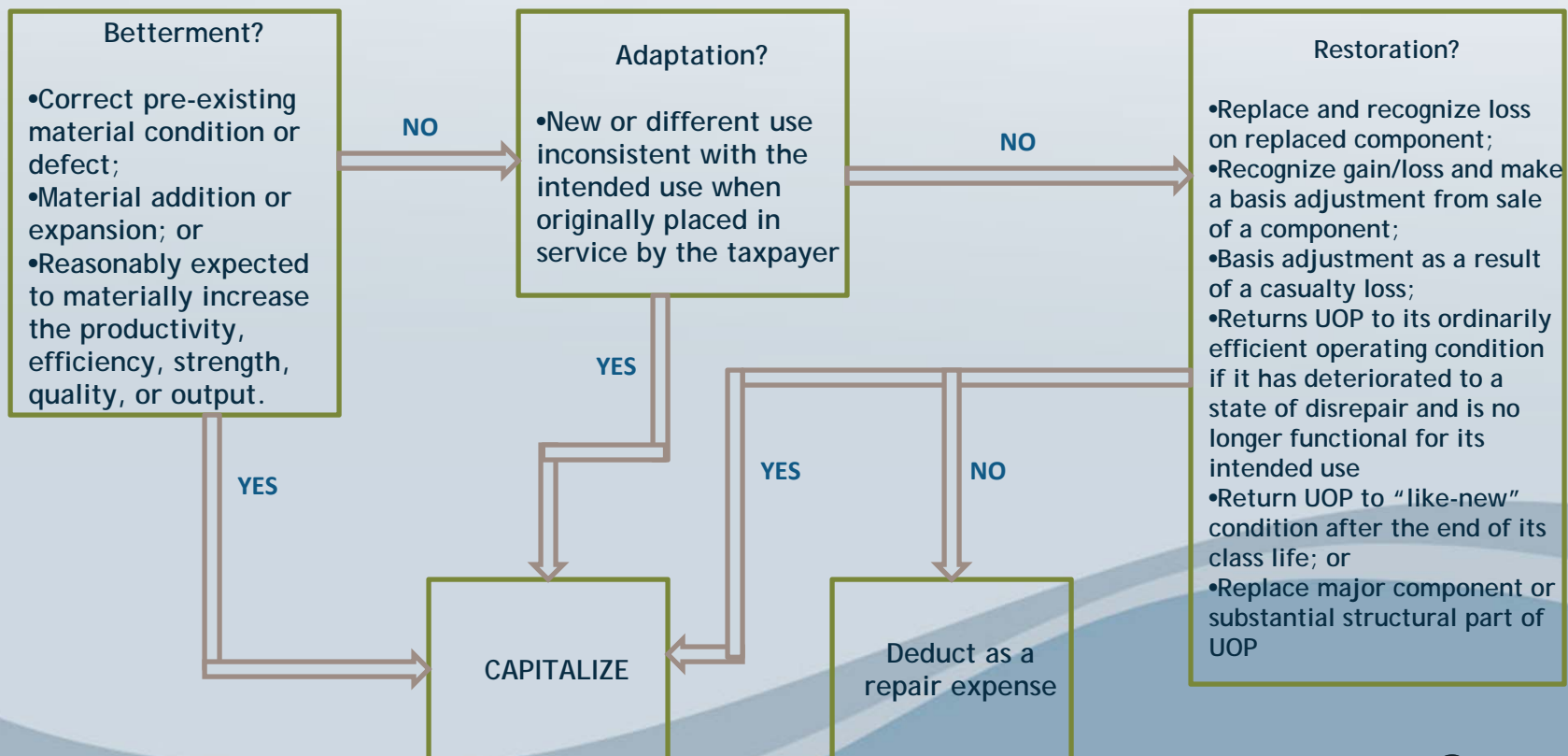


- Does not apply to:
 - Betterments
 - Adaptations
 - Restorations
 - Network assets
 - Certain rotatable spare parts
- Election to follow book treatment

Improvement Standards



- › Apply the following tests to the UOP to determine whether the expenditure is a capital expenditure:



Improvement Standards



- **Betterments – capitalize if:**
 - Pre-existing material condition or defect is corrected
 - Material addition or expansion
 - Reasonably expected to materially increase:
 - Productivity
 - Efficiency
 - Strength
 - Quality
 - Output

Betterment Examples



A taxpayer replaces wooden shingles with comparable asphalt composite shingles. The new shingles are not an material increase in quality, capacity, productivity or efficiency, and therefore are NOT A BETTERMENT.

However, if the new shingles are replaced with new shingles that are maintenance free, have a longer warranty period, or with a significantly higher fire rating, then the new shingles are a BETTERMENT and require capitalization. Example 3

A retail chain refreshes its stores to maintain the appearance and functionality of its store buildings after several years of wear. The work consists of replacing and reconfiguring display tables and racks to provide better exposure of the merchandise, lighting relocations, flooring repairs, moving one wall to accommodate the reconfigured tables, patching holes in walls, repainting, replacing ceiling tiles, cleaning flooring, and power washing the building. The display tables and racks constitute 1245 property.

The refresh is NOT a BETTERMENT because it did not materially increase the productivity, efficiency, strength, quality, or output of the building structure or system. Taxpayer must capitalize the amounts paid for the 1245 property. Example 6

Same as above, except, in the course of the refresh to one of its store buildings, the taxpayer also pays amounts to increase the storage space, add a second loading dock, a second overhead door, and upgrades to the electrical system at the same time as the refresh.

Amounts paid to increase storage space, add loading dock, install overhead door, and for electrical upgrades are deemed BETTERMENTS and must be capitalized. However, for reasons discussed in the above example, taxpayer is not required to treat the amounts paid for the refresh as a betterment. Example 7

Improvement Standards



- **Aadaptations – capitalize if:**
 - New or different use from intention when originally placed in service

Adaptation Examples



A taxpayer owns a building consisting of retail spaces that were designed to be reconfigured. One tenant wishes to expand its occupancy to include two adjoining retail spaces. The taxpayer pays an amount to remove the walls between the three retail spaces. Assume the walls between spaces are part of the building and its structural components.

Amounts paid to convert the retail spaces into one larger space for a tenant **DOES NOT ADAPT** taxpayer's building structure to a new or different use and is not required to be capitalized. Example 2

Taxpayer owns a grocery store. Taxpayer decides to add a sushi bar for its customers. Expenditures were made for counter and chairs, additional wiring and outlets, additional pipes and a sink, replacement of flooring and wallcoverings.

The amount paid to convert part of the retail grocery to a sushi bar is **NOT an ADAPTATION**. The sale of sushi is consistent with the taxpayer's intended, ordinary use of the building structure and the systems in the grocery sales business, which includes selling food to its customers at various specialized counters. Example 6

Amounts paid by ManuCo to re-grade land for residential purposes adapts the land to a new or different use that is different than ManuCo's original use.

Therefore, the costs to re-grade the land must be capitalized as an **ADAPTATION** of the property to a new or different use. Example 4

Improvement Standards



- **Restorations – capitalize if:**
 - Returns UOP to ordinary efficient operating condition if deteriorated to state of disrepair and no longer can function for intended use
 - Returns UOP to “like-new” condition at the end of its ADS class life
 - Replaces major component or substantial structural part of UOP
 - Replaces UOP where loss recognized on replaced component

Restoration Examples



RESTORATION

Replacement of the entire roof (decking, insulation) – Example 14

Replace chiller in office HVAC system (consists of one chiller, one boiler, pumps, duct work, diffusers, air handlers) – Example 16

Replacement of sprinkler system in a building – Example 19

Retail business replaces the plumbing fixtures in all of its restrooms (no piping) – Example 22

Hotel replaces all bathtubs, sinks in hotel rooms in 4 of the 20 floors; intends to complete renovation of the remaining rooms over next 2 years – Example 23

Replaces 200 of the 300 exterior windows (total windows are 25% of the building surface area) – Example 26

Replaces 100 of 300 windows, but the windows cover 90% of the building surface – Example 27

Replace all floors in the public areas of a hotel – public areas represent 40% sq ft – Example 29

NOT A RESTORATION

Replacement of waterproof rubber membrane – Example 15

Replacement of one furnace – HVAC system consists of 3 furnaces, duct work, etc. – Example 16

Replacement of 3 of 10 rooftop units in HVAC system – HVAC system consists of 10 rooftop units, ductwork, etc. – Example 18

Replace 30% of wiring to meet building code – Example 21

Replace 8 of 20 sinks in restrooms in a retail store (no piping) – Example 23

Replace 100 of 300 exterior windows (windows cover 25% of exterior surface) – Example 25

Replace flooring in lobby – 10% of the sq. ft. of the entire hotel building – Example 29.

Dispositions - Definition



- Asset's ownership transferred or permanently withdrawn from use in business or for production of income
 - Sold or exchanged
 - Retired
 - Physically abandoned
 - Destroyed/Casualty
 - Scrap
 - Involuntary Conversion
 - Partial disposition (*New Proposed Regs*)

Partial Disposition Election



- Claim loss upon the disposition of a structural component (or portion thereof) of a building without identifying the component as an asset before the disposition
- Methods to determine basis of partial disposition
 - Discounted replacement cost
 - Pro-rata replacement cost
 - Cost Segregation

Partial Disposition Election



- Proposed Regulations on Partial Dispositions
 - Election made in year disposition occurs by writing off the remaining net tax basis at time of disposition
 - Use it or lose it – depreciation of “ghost” asset
 - One-time catch up to write off “ghost” assets currently on depreciation schedules – may early adopt for 2012 or 2013

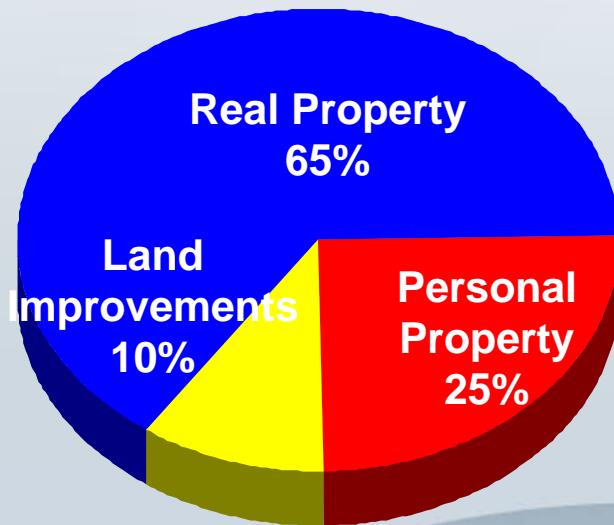
Cost Segregation



Before



After



Elections and Method Changes



Issue	Report on the Tax Return	Attach an Annual Election to the Tax Return	Accounting Method Change
De Minimis Policy		X	
Book Capitalization Policy		X	
Safe Harbor for Small Taxpayers		X	
Partial disposition		X	
Capitalization vs. Repairs			X
Disposition of a Component of a Building			X – under temp. regs.
Materials and Supplies			X
Annual Election to Capitalize and Depreciate Rotable and Temporary Spare Parts	X		

Year End Musts



- Review/revise, or establish, written capitalization policy before 1/1/14
- Review depreciation schedules for “ghost assets” and partial disposition opportunities
- Review R&M policy & tracking
- Review M&S policy & tracking
- Consider early adoption if favorable

Questions?



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