Tax Impacts Bulletin

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Final Tangible Property Regulations

Effective for tax years beginning on or after **January 1, 2014**, the final tangible property regulations **mandate** sweeping changes for amounts paid to acquire, produce, or improve tangible property. These complex regulations **will impact virtually all taxpayers** for the upcoming filing of calendar year 2014 income tax returns.

OVERVIEW

These regulations come after years of taxpayer uncertainty as to whether expenditures are repairs (expensed in the current year) or capitalized improvements (depreciated over time). Now, under new regulations the taxpayer is provided a general framework for distinguishing capital expenditures from deductible supply, repair and maintenance costs via the **B**etterment, **A**daptations, and/or **R**estorations ('**BAR**') standards. In addition, the regulations provide further clarity for the tax treatment of materials and supplies, rotable parts, and temporary spare parts.

WHAT DOES THIS MEAN FOR MY BUSINESS?

The regulations offer potential benefits to taxpayers in a number of areas. Safe harbors are available to allow immediate expensing of de minimis expenditures and certain routine maintenance. The 'BAR' standards may provide opportunity to currently deduct improvement projects as repairs that previously would have been capitalized and depreciated. Improvement projects that do not qualify as repairs may still provide a benefit to taxpayers by using the partial asset disposition election that was created in these regulations. Further, there is a one-time chance to catch up on partial asset dispositions on the 2014 tax return that may create significant deductions.

The flip side to potential opportunity is potential risk. Since the regulations allow for the taxpayer to make favorable accounting method changes they also allow for the IRS to revisit prior repair expenses, apply the new framework, and determine if past repairs should have been capitalized vs. expensed. To add insult to injury, if a repair should have been capitalized, the IRS will disallow the deduction – not just a loss in one year, recaptured in a later year, but a complete loss of the deduction.

CHANGE OF ACCOUNTING METHODS IN 2014

On top of the potential risk is **unavoidable administrative burden**. All historical tax treatments of repairs, materials & supplies, and capital expenditures are deemed to be established accounting methods by the IRS. In order to adopt the new regulations (**which are mandatory**), the IRS asserts that taxpayers will have to formally change accounting methods to demonstrate compliance with the regulations. A formal accounting method change involves additional computations and the filing of a special-purpose form (Form 3115) along with your 2014 tax return. The cumulative taxable income effect of adopting the regulations will be either deducted in full in the current year or includible in taxable income over the next four tax years. Please note that filing a 3115 in 2014 is an "automatic change" and the normal scope limitations are waived for 2014 taxable years. Subsequent to 2014, taxpayers may be precluded from filing automatic accounting method changes under these regulations which results in a $7,000 filing fee to comply. Representatives of the IRS and Treasury have stated in informal comments made in public forums that they expect most taxpayers to file a Form 3115 to implement these new rules. **Failure to comply presents risks to you, and may require us to file an additional disclosure form if you do not comply**.

HOW MANY???

There are up to 25 different accounting methods or elections that might need to be made; however, most taxpayers should anticipate looking at **the three most common**:

1. **Formally adopting a method of accounting for treating materials and supplies on hand.** Since most businesses have some sort of materials and supplies, we expect this to be a very common method change this year. One of the changes in this area would allow every taxpayer to establish a capitalization threshold, which until now had not been authorized under tax law.
2. **Adopting the new "unit of property" capitalization regime.** Method changes in this area will be particularly important for real property owners, but will likely also apply to manufacturers, or any business that is a tenant in leased real property. This regime also provides for determining deductible repair costs, as well as introducing a new safe-harbor for repairs and maintenance in certain situations.
3. Related to the previous method change, **any taxpayer adopting the "unit of property" regime may be eligible to take partial dispositions of previously capitalized assets**. This could result in accelerating deductions into 2014, which is a welcome raft of good news in this sea of administrative complexity.

WHAT TO-DO NOW

Given the far-reaching effects of these regulations, we recommend that all of our clients do the following:

- Create or revise your written capitalization policy
- Analyze your depreciation schedules for capitalized building improvements and/or incorrect lives or methods
- Assess current policies for tracking repairs and maintenance expenses and consider revising to align with the final regulations
- **Contact your Perkins tax advisor** to discuss the implications of these rules to your business and the necessary reporting to comply with them on your 2014 tax returns