Overview

Tangible Property Regulations

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Introduction

New federal tax regulations fundamentally change the way we think about tangible property.

These tangible property regulations are effective for 2014 tax filings – i.e., tax years beginning in 2014. They apply to virtually all businesses and landlords that own or use tangible property and they include rules for acquisition costs, improvements, improvement vs. repair issues, depreciation, treatment of materials and supplies, and write-offs for totally or partially disposed-of assets, to name a few.

New tangible property regulations, effective for 2014 tax filings, fundamentally change the tax rules for tangible property.

A number of the more significant concepts and changes in the regulations are described below.

New Concept: Unit of Property

Unit of property is the basic unit for applying the tax rules that govern capitalizing tangible assets and asset improvements under the new regulations.

A unit of property consists of all components of a business asset that are considered *functionally interdependent*. For example, a battery-powered forklift is a single unit of property—even if chassis and battery are purchased from different vendors and then assembled—as neither component can be placed into service without the other.

There are special unit of property rules for buildings, leasehold improvements and plant property.

While a building is a unit of property, it must be broken down into its structure, systems and major components when applying the regulations' improvement standards.

- The building structure includes the foundation, roof, walls, partitions, floors, windows, ceilings and permanent coverings, such as paneling or tiling.

- Building systems include the following eight systems: HVAC, plumbing, electrical, elevators, escalators, fire protection, security, and gas distribution.

- A major component includes a part or combination of parts that perform a discreet and critical function in the operation of a building's structure or any one of its systems. For example, furnaces, air conditioners, and chillers are all components of a building's HVAC system.

For the landlord of a leased building, the unit of property is the building. For the tenant, the unit of property is the portion of the building subject to the lease.

In the case of plant property—machinery and equipment used for an industrial process—the unit of property consists of the individual components that, taken together, perform a major and discrete function. For example, in the case of a steel mill, the smelter is a separate unit of property.

Capitalize Acquisitions and Improvements, Deduct Repairs

A unit of property — consisting of all functionally interdependent components of a business asset — is the basic unit for applying new tax rules that govern tangible property.

Under the new rules, you generally capitalize expenditures to acquire or improve a unit of property. Repair costs are deducted.

The new tangible asset regulations generally require that you capitalize the direct and indirect costs of a tangible asset (unit of property) when acquired.

If you incur subsequent, additional expenditures for an existing unit of property, you also capitalize those costs as long as they constitute an *improvement* to the property.

For buildings, you capitalize expenditures that improve a building *or* a building system or major component and that are incurred after the building is placed in service. The capitalization rules are applied individually to the building and each building system and major component.

If subsequent expenditures are not considered an improvement, they're repair costs and are therefore deducted.

Improvements, Defined

An improvement is either a *betterment* to the unit of property, a *restoration* of the property, or an *adaptation* of the property to a new or different use. The definitions for each are as follows:

Betterment
An expenditure is considered a betterment if it:

- corrects a material defect or condition that existed prior to the acquisition of a unit of property or arose during its production,
- results in a material addition to the unit of property (i.e., an enlargement, expansion or extension) or increases its capacity, *or*
- can reasonably be expected to materially increase the property's productivity, efficiency, strength, quality or output.

Restoration
A restoration is an expenditure that results in any of the following:

- replaces a component of the property for which you've properly deducted a loss (other than a casualty loss),

- replaces a component of the property for which you've properly recognized the adjusted basis in realizing a gain/loss on its sale or disposition,

- repairs damage to property resulting from a casualty event, for property that has had a basis adjustment,

- returns the property to its ordinarily efficient operating condition, if it was in disrepair and no longer functional—including buildings in disrepair when purchased,

- rebuilds the property to like-new condition after the end of its alternative depreciation system class life, *or*

- replaces a major component, large physical portion or substantial structural part of the unit of property.

Adaptation
Expenditures that alter a unit of property such that it is suitable for a new or different use are considered adaptations, if the resulting use is not consistent with your original intent for the property when you placed it in service. For example, you add a walk-in medical clinic to your pharmacy, convert your manufacturing facility to a showroom or adapt your commercial property for residential use.

Examples that do *not* constitute an adaption include adding a sushi bar to a retail grocery store that already includes counters for prepared and made-to-order food, or a hospital that modifies its emergency room space to also include an outpatient surgery.

The new or different use standards are applied separately to a building structure and its building systems

The new regulations create two safe harbor elections for your capitalization policies, one with a $5,000 maximum threshold if you have an audited financial statement and another for $500 if you do not.

Without an election the threshold is $200.

De Minimis Safe Harbor

Safe harbors are provisions in laws or regulations that, if satisfied, provide protection from a penalty, liability or other negative consequence.

The new tangible property regulations create two de minimis safe harbors for your capitalization policies, depending upon whether your business has an *applicable financial statement*. An applicable financial statement under the new rules is one that is audited for other than tax reasons – for example, a filing with the SEC or with a creditor.

To take advantage of either safe harbor rule, you make an annual irrevocable election as part of your timely filed federal income tax return. You're also required to use the same capitalization policy both for accounting/financial reporting and for tax purposes.

- *Safe Harbor Election / No Applicable Financial Statement*

If you don't have an applicable financial statement, under the de minimis safe harbor you may deduct items that cost **less than $500** (determined on a per-item basis, as substantiated by the invoice) or have a useful life of less than 12 months. When calculating the cost of an item, include costs for transportation and installation.

- *Safe Harbor Election / With Applicable Financial Statement*

If you have an applicable financial statement, you may deduct items that cost **less than $5,000** (determined on a per-item basis) or have a useful life of less than 12 months.

- *No Safe Harbor Election*

If you don't make a de minimis safe harbor election, the maximum capitalization threshold is **$200**. This is because units of property that cost $200 or less are typically defined as materials and supplies.

Note that the safe harbor amounts are not absolute limits, or ceilings. If you can justify a higher threshold amount, perhaps based on industry norms, you may use that higher amount but you'll bear the burden of proof if audited by the IRS.

As a reprieve for small taxpayers who own or lease buildings, a new safe harbor may allow you to deduct building improvements rather than capitalizing them and depreciating them over time.

Safe Harbor for Small Taxpayers with Buildings

The tangible property rules also include a safe harbor for small taxpayers that own eligible buildings.

If you qualify for the safe harbor, you are not required to capitalize building improvements as long as the total amount you paid during the tax year for repairs, maintenance, improvements and similar activities on a specific building unit of property does not exceed *the lesser* of $10,000 or two percent of the building's unadjusted basis. Amounts paid under the de minimis safe harbor and routine maintenance safe harbor are included in the calculation. Your unadjusted basis is typically cost, although for a lessee it is the total undiscounted rent paid/to be paid over the life of the lease, including renewals. Further, the limit is applied on a building-by-building basis. The safe harbor does not restrict the total number of eligible buildings you can own.

This annual safe harbor election is available to *qualifying small taxpayers,* defined as businesses and landlords with average annual gross receipts of $10 million or less for the last three tax years.

An eligible building is a building unit of property with an unadjusted basis of $1 million or less that is owned or leased by a qualifying taxpayer. Note that the eligible building does *not* include anything not classified as a building—land improvements, for example—or any assets classified with a different life than that of the building.

Election to Capitalize Repair and Maintenance Costs

On an annual basis, you may elect to capitalize and depreciate (rather than deduct) selected repair and maintenance costs, as long as you also capitalize and depreciate them for accounting purposes.

The election does not apply to the repair and maintenance costs of rotable or temporary spare parts if you've elected to use the optional method described below.

Routine Maintenance Safe Harbor

The IRS recognizes that you'll necessarily incur costs to keep your tangible property in an efficient operating condition, and so it created the routine maintenance safe harbor rule.

This safe harbor generally allows you to expense the cost of certain activities that are considered routine and are reasonably expected to occur *more than once* over a specified period of time.

For property other than buildings and their structural components, that period is the alternative depreciation system class life of the property. For buildings and/or their structural components, the time period is ten years.

In a departure from previous tax rules for disposing of fixed assets, the new tangible property regulations allow for partial asset dispositions.

Asset Dispositions

A disposition occurs when you transfer ownership of an asset or component, or permanently withdraw it from use—including as a result of its sale, retirement, exchange, abandonment or destruction.

Partial Asset Dispositions

Under the new rules, you can now dispose of a portion of an asset. Historically, you could not. For example, if you replaced a major portion of the roof on your building and capitalized the roof replacement costs, under the old rules you were required to capitalize and depreciate the cost of the roof replacement *and* continue depreciating the portion of the roof you replaced. Now you can write off the remaining basis for the portion of the old roof that you replaced.

Generally, partial asset dispositions require an election to be filed with your tax return. There are, however, a small number of circumstances under which a partial disposition is mandatory even without an election, including a disposition resulting from a casualty event.

Removal Costs

If you dispose of all or a portion of an asset, the regulations include special rules to clarify the treatment of any associated removal costs.

If, upon disposition of an asset or component, you include its adjusted basis in calculating the gain or loss for tax purposes, you aren't required to capitalize the cost of removal as an improvement.

On the other hand, if you don't recognize the disposal for tax purposes, you must capitalize removal costs if they represent an improvement to the asset unit or property, or deduct those costs if they result from a repair.

Materials and Supplies

The tax treatment for materials and supplies depends on whether they're classified as incidental (deducted when purchased), nonincidental (deducted when used or consumed) or rotable or temporary spare parts (three options for tax treatment).

Materials and supplies are tangible property (excluding inventory) that are used or consumed in operations *and* are any of the following:

- a component acquired to maintain, repair or improve a unit of tangible property,
- fuel, water, lubricants and similar items that are reasonably expected to be used in 12 months or less,
- a unit of property with a useful life of 12 months or less, or
- a unit of property with a cost that is less than $200.

Materials and supplies must be classified as incidental, nonincidental, or rotable or temporary spare parts, with distinct tax rules for each. Generally, incidental and nonincidental items are considered to be routine and expendable, while rotable or temporary spare parts are not.

The tax treatment for each of these categories of materials and supplies is as follows:

Incidental Items
Incidental items are generally those for which no consumption records or physical inventories are required. Basic office supplies are one example.

Incidental items are deducted when purchased. They cannot be capitalized and depreciated.

Nonincidental Items
All materials and supplies that are not incidental are considered to be nonincidental. They are generally deducted in the year they are first used or consumed in your operations. They cannot be capitalized and depreciated.

For tax year 2014 and beyond, you must keep a physical inventory or other record of consumption for these nonincidental items. If you have filed a de minimis safe harbor election for the year, you're not required to keep such records for items that fall under your capitalization threshold.

Rotable or Temporary Spare Parts
Rotable spare parts are defined as materials and supplies that are:

- acquired for installation on a unit of property,
- removable from that unit of property,
- generally repaired or improved, *and* either
- reinstalled on the same or other property or stored for later installation.

Temporary spare parts are components that are intended to be used until replaced with a new or repaired part. A temporary spare tire is one example. It's only intended to replace a normal tire that has gone flat until that flat tire can be repaired or replaced.

The new tangible property regulations may provide substantial tax benefits for those with significant tangible assets.

However, they require a transition process to implement for tax year 2014, whether or not you're likely to benefit from the potential tax savings.,

Unlike incidental and nonincidental materials and supplies, you have options for the tax treatment of rotable or temporary spare parts. They can be treated in any of the following ways:

- *Capitalize, Then Deduct When Discarded*

As the default tax treatment, you cannot recover the cost of your spare parts until you dispose of them, whether that means selling, scrapping or other means.

- *Capitalize, Then Depreciate When Used*

Typically, capitalizing and depreciating these parts is the preferred method, as you can deduct your cost earlier than the deduct-when-discarded approach—and it's relatively simple to implement.

To adopt this approach requires an election, although you don't need to prepare a paper statement for this one. Simply implement it on your federal tax return for the year you acquire the part.

- *Optional Method*

The optional method is the most complicated approach. You begin by deducting the cost of the item in the year it is first installed.

When you remove the part, you include its fair market value in income and capitalize any removal or refurbishing costs. At that point, the tax basis for the part is the amount of income you recognized plus any capitalized costs.

If you reinstall it later, you deduct the part's tax basis and any reinstallation costs.

And if you remove it again, the cycle repeats until it is scrapped or otherwise disposed of.

Impact of the Regulations

The new tangible property regulations provide a level of clarity around this sometimes murky area of the tax code, as well as potential tax benefits and a number of planning opportunities.

However, as with any substantial new tax regulations, there are still minor changes being made and a few uncertainties remain.

Certain deductions related to prior tax years are available as part of the transition.

Repair deductions for previously capitalized assets, as well as partial asset dispositions from prior years can only be deducted on your 2014 tax return.

Transition Requirements and Potential Tax Savings for 2014

If you own or lease significant fixed assets or real property, the tangible property regulations offer the potential for greater current (2014) tax deductions on your federal income tax return, including for repair costs and materials and supplies.

Implementing the new rules requires a fairly complex and time-consuming transition process that includes a review of capitalized costs for current and prior years, new and revised calculations and various elections. It also requires preparing accounting method change forms, which are generally required whether or not you can benefit from the potential tax savings.

Repair Deductions for Previously Capitalized Assets
You or your tax advisor should review the assets on your existing depreciation schedules in light of the new rules. Based on retroactive aspects of these rules, certain previously capitalized assets may actually be deductible repairs.

If you don't deduct such repairs on your 2014 return, the IRS may disallow any future depreciation for those assets that do not pass the new capitalization criteria.

For example, assume ABC, Inc. capitalized a $40,000 roof expenditure ten years ago. Further assume that, under the new rules, the remaining tax basis of $30,000 should be written off on the 2014 tax return. If ABC does not properly complete the necessary one-time tax filings to implement this write-off, it will permanently lose the $30,000 as a tax deduction. It cannot continue to take annual depreciation for this item.

Partial Asset Dispositions
You should also look for any partial asset dispositions from prior years—including those that arise from asset replacements—to uncover possible tax benefits. The new regulations generally allow you to elect to recognize gain or loss on a partial disposition or to ignore the disposition and continue depreciating the asset.

As with the capitalization rules above, the ability to recognize gains or losses from prior-year partial dispositions is not available to you after the 2014 tax year, so it's important to analyze the potential tax benefits before you file your return.

Small Businesses and Form 3115 Application for Change in Accounting Method
New rules announced in February of 2015 simplify the transition process for small businesses—defined as those with total assets less than $10 million or average annual gross receipts of $10 million or less for the prior three tax years. For these businesses, filing IRS Form 3115 for certain accounting method changes under the tangible property regulations may not be required.

February 2015 rules simplify the transition for small businesses by offering a choice to apply certain rules prospectively. Small businesses that choose this option are not required to apply for a change in accounting method using IRS Form 3115.

Generally, if your small business chooses to apply the tangible property rules without the retroactive adjustments describe above, and instead apply the rules only for taxable years beginning on or after January 1, 2014, it is not required to file IRS Form 3115. However, by not filing Form 3115, you are not assured of audit protection if the IRS decides to audit your return.

Further, this option applies only to changes in accounting method that require Form 3115 filings. It does not eliminate the need to include election statements with your federal tax return for items that do not require a change in accounting method, such as the de minimis safe harbor election.

2015 and Beyond

Continued compliance with the new regulations requires a different way of thinking about tangible assets, as well as potential changes in recordkeeping, processes and procedures.

For example, under the new rules, you'll need to identify and track assets based on units of property. That means you can't simply capitalize assets based on invoice amounts.

Instead, you may be required to combine amounts from multiple invoices—for example, when various components are purchased separately or when building constructions costs involve many payments over a period of time. Alternatively, you may be required to allocate amounts from a single invoice to multiple units of property.

Responsibility of Tax Preparers

As your tax preparer, we are required by law to ensure that your 2014 return conforms to the new tangible property regulations and related form submission rules. In some cases, we may need to request additional supporting documents from you to substantiate the amounts reflected on your return.

We're prohibited from preparing and/or signing any return that does not conform to these new rules.

Tangible property rules are a complex area of the tax code and the new regulations represent fundamental changes.

If you have questions about the impact of the new tangible property regulations on your tax situation, give us a call.

The tangible property regulations are detailed and complex, and cannot be fully explained in this overview. If you have additional questions about the impact of these regulations on your tax filings, give us a call.

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